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Opportunities for Obtaining and Using Litigation Reserves and Disclosures

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In late 1975, the accounting and legal professions reached an accord that led to three new professional standards: (1) a new financial accounting rule for contingencies, (2) an auditing standard addressing the requirement that an auditor obtain evidence about an audit client's contingent liabilities to determine whether the client has properly treated those items in its financial statements, and (3) the American Bar Association's Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information under that auditing standard. The Commentary that accompanied the Statement of Policy explicitly stated that the organized bar's expectation that communications between lawyers and auditors in accordance with the Statement of Policy would not prove prejudicial to clients engaged in or facing adversary proceedings. If developments occurred to negate that expectation, the Statement of Policy recognized that the American Bar Association may need to review and revise both the Statement of Policy and the accord.

Using several recently settled cases as examples, this article shows that existing law often allows litigation opponents access to significant information about the evaluations of an enterprise's management, auditor, and attorneys about the enterprise's exposure in the litigation, potentially evidenced by amounts that the enterprise has already accrued as an expense under the financial accounting rules. Since the accord and the Statement of Policy, three important developments have significantly changed the then-present legal landscape: the enhanced federal securities law disclosures in the Management's Discussion and Analysis requirements, the Supreme Court's 1984 opinion in United States v. Arthur Young & Co., and the "economic performance" requirement that the Tax Reform Act of 1984 added to § 461(h) of the Internal Revenue Code. Given

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those developments, the article calls for a review of the accord and the Statement of Policy. Pending such review, this article also proposes a new rule of evidence that, similar to Rule 411 of the Federal Rules of Evidence on liability insurance, would allow the discovery of information about litigation reserves, but generally bar such information from admission into evidence at trial.

TABLE OF CONTENTS

I. INTRODUCTION.....	1021
II. PROFESSIONAL STANDARDS AFFECTING LITIGATION RESERVES AND THE CORRESPONDING BOOKS AND RECORDS, ACCOMPANYING DOCUMENTATION, ENSUING WORKPAPERS, AND RELATED INFORMATION	1030
A. <i>The Financial Accounting Rules and Resulting Documentation</i>	1032
1. <i>Pending Litigation, Claims, and Assessments</i>	1033
a. <i>Factors Affecting Financial Accounting Treatment</i>	1033
i. <i>Materiality</i>	1034
ii. <i>Underlying Event</i>	1034
iii. <i>Likelihood of an Unfavorable Outcome</i>	1035
iv. <i>Ability to Reasonably Estimate the Potential Loss</i>	1037
b. <i>Financial Accounting Alternatives</i>	1037
i. <i>Accrual of Loss Contingencies</i>	1037
ii. <i>Disclosure of Loss Contingencies</i>	1038
2. <i>Unasserted Claims</i>	1041
3. <i>Financial Accounting Information and Documentation Related to Loss Contingencies</i>	1042
B. <i>Auditing Standards and Related Documentation</i>	1047
1. <i>Audit Procedures</i>	1048
2. <i>Audit Workpapers</i>	1049
3. <i>Public Oversight Board</i>	1050
C. <i>Responses to Audit Inquiries</i>	1051
1. <i>Client Consent</i>	1052
2. <i>Limits on Permissible Use</i>	1053
3. <i>General Limitations on the Scope of the Response</i>	1054
4. <i>Materiality</i>	1055
5. <i>Types of Contingencies</i>	1056
6. <i>Specific Recommendations Regarding Disclosures</i>	1057
a. <i>Possibility of Unfavorable Outcome</i>	1057
b. <i>Estimate of Potential Loss</i>	1060

III. THREE SIGNIFICANT DEVELOPMENTS AFTER THE 1975	
ACCORD AND RELATED INFORMATION AND DOCUMENTATION	1060
A. <i>Management's Discussion and Analysis</i>	1061
B. <i>United States v. Arthur Young & Co.</i>	1067
C. <i>"Economic Performance" Requirement</i>	1069
IV. DISCOVERY OPPORTUNITIES	1081
A. <i>General Scope of Discovery</i>	1082
1. <i>Relevancy</i>	1082
2. <i>Absence of Privilege</i>	1087
a. <i>Attorney-Client Privilege</i>	1088
b. <i>Accountant-Client Privilege</i>	1091
B. <i>Other Defenses to Discovery Requests or</i> <i>Limitations on the Scope of Discovery</i>	1092
1. <i>Work Product</i>	1092
a. <i>Courts' Interpretations of</i> <i>"In Anticipation of Litigation"</i>	1094
i. <i>Primary Motivating Purpose Standard</i>	1095
ii. <i>United States v. Adlman:</i> <i>The "Because of" Test</i>	1097
iii. <i>Simon v. G.D. Searle & Co.:The Middle of the</i> <i>Gulf/Adlman Spectrum</i>	1098
b. <i>Waiver</i>	1100
2. <i>Limitations on the Scope of Discovery</i>	1101
C. <i>Potential Admissibility</i>	1102
V. CONCLUSION AND REFORM PROPOSAL	1102

I. INTRODUCTION

On January 12, 1995, shortly after filing bankruptcy petitions during the previous month, Orange County, California ("Orange County"), and various funds that the Orange County Treasurer-Tax Collector controlled for approximately 200 other municipal entities (the "Pools"), filed a lawsuit seeking more than \$2 billion in damages from Merrill Lynch & Co., Inc. and certain subsidiaries (collectively, "Merrill Lynch"). The lawsuit asserted both state and federal claims and alleged that Merrill Lynch failed to warn county officials about the riskiness and alleged unlawfulness of the derivatives-based investment scheme that ultimately led to the nation's largest municipal bankruptcy.¹ More than three years later, on June 2, 1998, Orange County and Merrill Lynch announced a more than \$400 million settlement to end the litigation.² In its press release, Merrill Lynch "announced that it was fully reserved for the settlement and 'that the payment will have no financial impact on earnings reported in the 1998 second quarter or subsequent quarters.'"³

What does that press release tell us? That announcement indicates that sometime before April 1, 1998, the start of Merrill Lynch's second quarter, the company had expensed more than \$400 million related to the litigation against earnings and had either recorded liabilities, written off assets, or some combination of both on its balance sheet to the tune of that same \$400 million-plus.⁴ Although a diligent review of Merrill Lynch's financial statements for, and

¹ County of Orange v. Merrill Lynch & Co., Ch. 11 Case No. SA 94-22272JR, Adv. No. CV-95-0037-GLT (Bankr. C.D. Cal. filed Jan. 12, 1995).

² In addition to agreeing to a \$400 million payment, Merrill Lynch reportedly agreed to return some \$20 million in excess collateral for distribution to the Pools and to pay \$17.1 million to the Irvine Ranch Water District to settle a related suit. Andy Pasztor et al., *Merrill Lynch to Pay \$437.1 Million to Resolve Claims by Orange County*, WALL ST. J., June 3, 1998, at A3; see also *Merrill Lynch to Pay \$400 Million to Settle Orange County Bankruptcy Suit*, 30 SEC. REG. & L. REP. (BNA) 846 (1998).

³ *Merrill Lynch to Pay \$400 Million to Settle Orange County Bankruptcy Suit*, *supra* note 2; see also Pasztor et al., *supra* note 2.

⁴ Such expenses would reduce the company's profit or loss for the particular accounting period. During litigation, some enterprises record estimated losses for financial accounting purposes and also establish or increase a corresponding liability, sometimes described as a "reserve" or "provision." Accountants use the terms "reserve" and "provision" to refer to anticipated liabilities when uncertainty exists about the amount or timing of the transfer of the economic benefits that the obligation's payment or satisfaction will entail. As such, "litigation reserve," "litigation contingency reserve," "reserve for litigation," and similar terms all refer to amounts arising from an expected loss or potential settlement related to anticipated or pending litigation that an enterprise has treated as an expense, but has not yet paid. Because the enterprise has not paid the corresponding obligation, the enterprise's balance sheet will treat the estimated amount owed as a liability.

Several other points about such "accrued expenses" merit mention at this time. First, the term "accrued expenses" refers to expenses that an enterprise has subtracted from income, but not yet paid. Some accountants have suggested that in any case in which an enterprise must estimate the amount of an expense, the enterprise should use a different name for any corresponding liability created. For this reason, some enterprises use the term "Estimated Liability" to describe the obligation arising from these accrued expenses. Thus, an enterprise might call the liability created when accruing an expense related to anticipated or pending litigation "Estimated Liability for Litigation" rather than "Litigation Liability Payable" or "Accrued Litigation Costs Payable." Such nomenclature presumably allows a reader to separate such liabilities from others that qualify as unconditional, whether or not due yet, and certain in amount. No uniform practice exists on this matter, however, and many enterprises lump all their liabilities arising from accrued expenses under a single heading like "Accrued Liabilities," "Other Current Liabilities," or "Other Liabilities" on their balance sheets.

Because lawyers will often encounter various terminology describing accrued liabilities, some history about this vocabulary also warrants discussion. At one time, accountants used the term "reserve," as in "Reserve for Litigation Expense," to signify estimated or conditional liabilities. Because the term connotes setting something aside, presumably assets, to satisfy the underlying liability, the term can easily mislead an unsophisticated reader.

Any time an enterprise accrues an expense, the accrual lowers net income for the accounting period, which in turn reduces retained earnings, and net assets, at the end of the period. As a result, any such accrual adversely affects the amount that an enterprise could lawfully distribute to its owners. An enterprise, however, can also set aside cash or other liquid assets and specifically earmark those assets for a particular purpose, such as discharging an obligation arising from litigation or paying for a new plant. For example, the enterprise might establish a formal escrow arrangement or, less formally, simply open a special bank account. The term "reserve," unfortunately, suggests that the enterprise has established some such arrangement. In fact, however, calling the liability a "reserve" means nothing more than that the enterprise created a liability and estimated the amount in conjunction with accruing an expense.

Loose terminology has often accompanied the term "reserve" in related contexts. Judicial opinions, for example, sometimes refer to "deducting the reserve from income" or "reserves out of income." Presumably, this language seeks to express the fact that the enterprise created a reserve account in conjunction with a charge against income in exactly the same amount. Such phrases, however, can confuse a reader, because the term "reserve" describes a liability which appears on the balance sheet, and liabilities themselves do not affect the determination of net income.

Given these concerns, Accounting Terminology Bulletin No. 1 urged that the accounting profession narrowly confine the word "reserve" and recommended that enterprises discontinue the term's use to describe the liability accompanying an accrued expense. REVIEW AND RÉSUMÉ, Accounting Terminology Bulletin No. 1, ¶ 60 (American Inst. of Accountants 1953). In fact, however, the term "reserve" still appears in accounting and legal materials. A 2000 survey by the American Institute of Certified Public Accountants ("AICPA") of accounting practices followed in 600 annual reports shows that the term "reserve" continues to appear occasionally in financial statements to describe accruals for estimated expenses, insurance, environmental costs, and other liabilities. AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, ACCOUNTING TRENDS & TECHNIQUES 299 (54th ed. 2000).

To complicate matters further, the term "reserve" can also refer to a so-called "contra-asset account," such as "Reserve for Doubtful Accounts," that an enterprise might use to write-down

as of the end of, the quarterly and annual periods published after the lawsuit's filing and before the settlement does not reveal either the previously expensed amounts or any related liabilities or asset write-downs,⁵ a careful reading of the

an asset, such as an uncollectible accounts receivable. As the name suggests, a *contra-asset account* records reductions in a particular asset account, such as Accounts Receivable, separately from the relevant asset account. Paralleling the normal practice of crediting an estimated liability account when an enterprise, such as Merrill Lynch, accrues an expense or loss prior to payment, when writing down an asset, such as an accounts receivable from Orange County or the Pools that Merrill Lynch may have agreed not to collect to settle the litigation, the enterprise could correspondingly credit an account, which we can consider for the moment as an estimated liability, to reflect the write-down. Two important differences, however, distinguish such an account from other estimated liability accounts. First, this estimated-liability-type account does not represent a liability to pay money or perform services, but rather represents the fact that the business will not actually collect some money which, by recording various accounts receivable, the enterprise projected it would receive. Second, the account created to reflect such uncollectible accounts often appears on the balance sheet as an offset to accounts receivable, rather than separately as a liability, to give a more accurate picture of how much cash the enterprise actually expects to obtain from the receivables. Perhaps for these reasons, enterprises usually do not use an "Estimated Liability" caption for such an account. In modern accounting practice, most enterprises commonly call the account something like "Allowance for Doubtful Accounts" or "Allowance." *Id.* at 200. Other enterprises may use other names, such as "Reserve for Uncollectible Accounts" or "Reserve for Bad Debts," for such a contra-asset account. In addition, the Securities and Exchange Commission ("SEC") uses the term "reserve" in this same context. *See, e.g.*, 17 C.F.R. § 210.12-09 (2002) (valuation and qualifying accounts and reserves not included in specific schedules). The fact that Merrill Lynch's 1997 and 1996 Form 10-Ks do not contain such a listing suggests that the company treated the entire \$400 million previously expensed as an accrued liability.

One final possibility also requires mention. Merrill Lynch may have purchased insurance to protect the company against losses from its employees' errors and omissions. If insurance covered the settlement, either by paying the settlement directly or reimbursing Merrill Lynch for amounts the company incurred to settle the litigation, the settlement also would not have affected current or future earnings. If Merrill Lynch had carried insurance against such losses, either the press release announcing the settlement or the company's public filings with the SEC presumably would have mentioned such insurance.

⁵ Beginning with Merrill Lynch's consolidated financial statements for the fiscal year ending December 30, 1994, which describes the filing of the Orange County litigation as a subsequent event in the note captioned "Commitments and Contingencies," the only specific reference to that litigation in the financial statements themselves occurs in the "Notes to Consolidated Financial Statements." MERRILL LYNCH & CO., 1994 ANNUAL REPORT TO STOCKHOLDERS 44-45 (1995) [hereinafter 1994 MERRILL LYNCH ANNUAL REPORT], *included as Exhibit 13 to MERRILL LYNCH & CO., FORM 10-K, ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (for the fiscal year ended Dec. 30, 1994) (filed Mar. 28, 1995) [hereinafter 1994 MERRILL LYNCH FORM 10-K].* Through the consolidated financial statements for the fiscal year ending December 26, 1997, the notes on "Commitments and Contingencies" update the status of the litigation and conclude with almost identical statements to the effect:

company's public filings with the Securities and Exchange Commission ("SEC") offers some important clues into Merrill Lynch's accounting practices. Repeating amounts from the financial statements, the supplemental tables for "Non-Interest Expenses" in the Management's Discussion and Analysis ("MD&A") section of Merrill Lynch's Form 10-Ks for the fiscal years ended December 27, 1996 and December 26, 1997, which the company filed with the SEC on March 21, 1997 and March 3, 1998, respectively, reveal that other non-interest expenses, excluding compensation and benefits, increased from \$697 million in fiscal 1995 to \$859 million in fiscal 1996 and to \$1,136 million in fiscal 1997.⁶ In the accompanying textual discussion, the MD&A for fiscal 1997 remarkably comments: "Other expenses increased 32% from 1996 due to increases in provisions for various business activities and legal matters, and higher office and postage costs."⁷ That textual discussion also contains another statement that previously appeared in the MD&A for fiscal 1996: "Other expenses rose 23% due in part to provisions related to various business activities and goodwill amortization."⁸

Although the ultimate outcome of [the Orange County litigation] cannot be ascertained at this time and the results of legal proceedings cannot be predicted with certainty, it is the opinion of management that the resolution of these matters will not have a material adverse effect on the Consolidated Financial Statements of Merrill Lynch contained herein.

MERRILL LYNCH & CO., 1997 ANNUAL REPORT TO STOCKHOLDERS 56 (1998) [hereinafter 1997 MERRILL LYNCH ANNUAL REPORT] (note 7), *incorporated by reference in* MERRILL LYNCH & CO., FORM 10-K, ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (for the fiscal year ended Dec. 26, 1997) (filed Mar. 5, 1998) [hereinafter 1997 MERRILL LYNCH FORM 10-K]; MERRILL LYNCH & CO., 1996 ANNUAL REPORT TO STOCKHOLDERS 59 (1997) [hereinafter 1996 MERRILL LYNCH ANNUAL REPORT] (note 7), *included as* Exhibit 13 to MERRILL LYNCH & CO., FORM 10-K, ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (for the fiscal year ended Dec. 27, 1996) (filed Mar. 21, 1997) [hereinafter 1996 MERRILL LYNCH FORM 10-K]; MERRILL LYNCH & CO., 1995 ANNUAL REPORT TO STOCKHOLDERS 63-64 (1996) (note 17), *included as* Exhibit 13 to MERRILL LYNCH & CO., FORM 10-K, ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (for the fiscal year ended Dec. 29, 1995) (filed Mar. 22, 1996); 1994 MERRILL LYNCH ANNUAL REPORT, *supra*, at 45 (notes not numbered and different capitalization).

⁶ 1997 MERRILL LYNCH FORM 10-K, *supra* note 5, at 198-99; 1996 MERRILL LYNCH FORM 10-K, *supra* note 5, at 18-19 (referencing the MD&A discussion in the 1996 MERRILL LYNCH ANNUAL REPORT). Please notice that this information appears on pages 198-99 of the 267 page Form 10-K for fiscal 1996 and pages 18-19 of the 165 page Form 10-K for fiscal 1997.

⁷ 1997 MERRILL LYNCH FORM 10-K, *supra* note 5, at 18.

⁸ *Id.* at 19; *see also* 1996 MERRILL LYNCH FORM 10-K, *supra* note 5, at 199. Incidentally, the 1996 Merrill Lynch Form 10-K does not mention any "provisions related to various business activities" during the discussion detailing non-interest expenses for fiscal 1995. *Id.*

As counsel for Orange County, would you find this information helpful? Assuming that Merrill Lynch had previously expensed amounts related to its expected loss in the litigation against earnings under the applicable financial accounting rules, collectively say \$400 million over various accounting periods after Orange County and the Pools filed the underlying lawsuit, and included a corresponding \$400 million liability, sometimes called a “litigation reserve” or a “litigation contingency reserve,”⁹ on its March 31, 1998 balance sheet, could Orange County extract information about such accruals during discovery, either from Merrill Lynch or from Deloitte & Touche LLP, the company’s auditor? Would the total amount that Merrill Lynch had previously expensed become a de facto “floor” below which Orange County would refuse to drop in any settlement negotiations? If Merrill Lynch expensed additional amounts as additional losses related to the lawsuit as the litigation progressed, could Orange County obtain information about any such adjustments? Would any such accrual constitute an admission against interest?¹⁰

Although counsel for both Orange County and Merrill Lynch have quite understandably declined to discuss the specifics of the litigation, the former specifically mentioning a confidentiality agreement, this article opines that counsel for Orange County could have potentially used the disclosures in the MD&A to try to gather additional information about the exact amount of the accrued liability on Merrill Lynch’s books, certainly before agreeing to any settlement and perhaps for use at trial as an admission against interest.¹¹

How could counsel for Orange County use these disclosures to gather additional information, financial or other, about the underlying case? What other potential sources of information about litigation reserves might counsel for Orange County have sought to obtain during the discovery process? This article suggests that counsel for Orange County might have scheduled depositions or submitted interrogatories and requested the production of various documents to obtain a detailed listing of each item above a certain figure, say \$5 million, included in the \$697 million, \$859 million, and \$1,136 million groupings. In the context of this same litigation between Orange County and Merrill Lynch, this article describes several other sources of accounting-related information about litigation reserves or disclosures that plaintiffs’ attorneys, in particular, may find useful.

⁹ For an explanation regarding the terms “litigation reserve” and “litigation contingency reserve,” see *supra* note 4.

¹⁰ See FED. R. EVID. 801(d)(2)(A).

¹¹ If Merrill Lynch and Orange County had not settled the underlying litigation, concern about the effect my research might have had on that litigation would have made me reluctant to use this example as a case study. For this same reason, this article does not knowingly offer any examples involving currently pending litigation.

Putting aside the litigation between Orange County and Merrill Lynch, numerous other recent examples illustrate this opportunity for obtaining and using accounting-related information about an underlying lawsuit in litigation. In similar fashion to the Orange County settlement, and again without admitting any wrongdoing, Merrill Lynch agreed in May 2000 to pay Sumitomo Corp. \$275 million and legal fees to settle a lawsuit that sought to recover about \$1.7 billion in losses that Sumitomo suffered during a 1996 copper trading scandal. Again, Merrill Lynch announced that the settlement would "not have a material impact on earnings reported in the second quarter of 2000."¹² About a year earlier, in July 1999, *The Wall Street Journal* published an article that stated that Walt Disney Co. ("Disney") had agreed to pay an undisclosed amount exceeding \$250 million to settle Jeffrey Katzenberg's breach of contract lawsuit against the company.¹³ The day before, the newspaper reported that "Disney told Wall Street analysts that it has reserved for the amount of the settlement, which will have no impact on its earnings."¹⁴ More recently, Bank of America Corp. (the "Bank") agreed in February 2002 to pay \$490 million to settle shareholder lawsuits arising from the write-down of a loan to D.E. Shaw & Co.¹⁵ In its press release announcing the agreement, the Bank stated that it would pay the settlement from existing litigation reserves and insurance and that the agreement would have "no impact on the company's financial results."¹⁶

¹² Barry Hall, *Merrill to Pay Sumitomo \$275 Million to Avoid Suit Over '96 Copper Scandal*, 32 SEC. REG. & L. REP. (BNA) 753, 754 (2000).

¹³ Bruce Orwall, *Observers Second-Guess Disney Handling of Feuds*, WALL ST. J., July 9, 1999, at B3.

¹⁴ Bruce Orwall, *A Conclusion in the Clash of Hollywood Titans*, WALL ST. J., July 8, 1999, at B1.

¹⁵ Carrick Mollenkamp, *Bank of America to Settle Shareholder Suits*, WALL ST. J., Feb. 11, 2002, at A11. For a general description of the underlying litigation, see *infra* note 172.

¹⁶ Press Release, Bank of Am. Corp., *Bank of America Agrees to Settle Merger-Related Lawsuits* (Feb. 8, 2002), <http://www.bankofamerica.com/newsroom/press/press.cfm?PressID=press.20020208.02.htm&LOBID=9> (last visited Oct 20, 2002). According to a spokesperson for the Bank, "the company's legal insurance paid for about 40% of the \$490 million settlement, or approximately \$196 million." Mollenkamp, *supra* note 15. Subtracting that amount from the \$490 million settlement means that the Bank agreed to pay about \$294 million.

The Bank's 2001 Annual Report states that the Bank "recorded \$334 million in litigation expense in the fourth quarter of 2001 related to small settlements and an addition to the legal reserve to cover increased exposure in existing litigation." BANK OF AM. CORP., 2001 ANNUAL REPORT 34 (2002), <http://www.bankofamerica.com/investor/index.cfm?section=700>. Interestingly, while the Bank set aside the amount for the fourth quarter of 2001 and released its financial results for that period on January 22, 2002, it reportedly did not begin settlement talks until mid-January. See Mollenkamp, *supra* note 15 ("[P]laintiffs' attorneys [in mid-January, 2002] approached Bank of America to pursue a settlement. . . . [E]ventually, \$490

This article argues that existing law often allows a savvy litigator to use the discovery process to obtain very helpful data about any litigation reserves or contingencies¹⁷ related to an underlying lawsuit by: (1) examining an opponent's (a) financial statements, (b) books and records, (c) tax returns, including any related revenue agent reports proposing changes to those returns, and (d) correspondence with any outside auditor; (2) reviewing the opponent's public filings, if any, with the SEC and other regulatory agencies, such as a public utilities commission or department of insurance, in their entirety for financial information or disclosures regarding the underlying litigation; (3) requesting information concerning the litigation and any related litigation reserves from any outside auditor, specifically including those portions of the audit workpapers containing: (a) schedules and supporting documentation detailing litigation reserves or litigation contingencies, (b) management's letter, and (c) the response of the opponent's attorney to the audit inquiry letter; and (4) seeking any records or information from the Public Oversight Board ("POB"),¹⁸ SEC Practice Section, Quality Control Inquiry Committee, and AICPA Professional Ethics Division regarding quality control inquiries to review allegations of audit failures contained in litigation filed against member firms in any lawsuit involving auditor malpractice. Anecdotal evidence, however, indicates that plaintiffs often do not pursue these opportunities during the discovery process.

Under certain circumstances, generally accepted accounting principles ("GAAP") require an enterprise to accrue an expense and usually record a corresponding liability for various loss contingencies, including pending lawsuits. In such scenarios, the discovery rules in the current Federal Rules of Civil Procedure often enable an enterprise's opponent in litigation to obtain information about the enterprise's estimate of its potential liability in any underlying litigation involving a federal issue, such as the federal antitrust, bankruptcy, environmental, labor discrimination, or securities laws, especially

million was offered from the Bank of America side."). This report suggests that the Bank had not yet reached an agreement in principal with the plaintiffs when it accrued \$334 million for the fourth quarter.

¹⁷ The term "litigation contingency" refers to any potential loss stemming from litigation, whether or not an enterprise accrues the amount on its financial statements.

¹⁸ As discussed in note 87, *infra*, and accompanying text, until the POB ceased operations on May 1, 2002, the organization investigated litigation alleging audit failures involving publicly traded enterprises to determine whether the auditor needed to take corrective actions to strengthen its procedures or to address personnel deficiencies. Following the collapse of Enron Corp. and the announcement of a staggering financial fraud at WorldCom, Inc., Congress passed the landmark Sarbanes-Oxley Act of 2002. Pub. L. No. 107-204, 116 Stat. 745. That legislation establishes the Public Company Accounting Oversight Board to investigate and discipline registered public accounting firms and associated persons, but specifically protects the Board's records from "civil discovery or other legal process." *Id.* §§ 101(a), (c), 105(a), (b)(5)(A), 116 Stat. at 750-51, 759, 761.

when the enterprise's personnel discuss the accrual with an outside auditor or when the enterprise provides some bland disclosure about the accrual in a public report. Even if the enterprise has not recognized an expense and related liability for financial accounting purposes, the discovery rules also generally permit a litigation opponent to review certain information related to the litigation in the files of the enterprise's auditor, including evaluations of the enterprise's estimate of its potential liability by the auditor, the enterprise's attorneys, and, in cases involving auditor malpractice, the POB or any successor. To date, no other article comprehensively discusses the potential opportunities, especially for plaintiffs, for using information about litigation reserves in the underlying litigation.¹⁹

As background, Part II of this article overviews the professional standards underlying the 1975 treaty between the accounting and legal professions, primarily Statement of Financial Accounting Standards No. 5, Accounting for Contingencies ("SFAS No. 5"), which generally sets forth the financial accounting rules regarding contingent liabilities; Statement of Auditing Standards No. 12, Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments ("SAS No. 12"), which discusses an auditor's obligation to obtain evidence about contingent liabilities to determine whether an enterprise has properly treated those items in its financial statements and to request corroborating information from the enterprise's outside counsel during any audit; and the American Bar Association's Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (the "ABA Statement of Policy"), which sets forth the legal profession's official policy on responses to audit inquiry letters. This part also describes the particular places within an enterprise's financial statements and books and records where an attorney may find information regarding a particular litigation contingency. In addition, this part begins to identify other sources for information and documentation

¹⁹ Several articles discuss certain aspects of these issues. See, e.g., Matthew A. Hodel & Charles A. Burke, *Attorney Audit Letters: The Argument Against Discovery*, L.A. LAW., Mar. 1991, at 23 (concluding that existing privileges and policies protect audit inquiry responses from discovery); Douglas G. Houser & Jeremy E. Zuck, *Insurance Claim Reserves: Are They Admissible? Or, What the Claimants Don't Know Can Hurt You*, 52 INS. COUNS. J. 152 (1985) (considering insurance reserves); Gita F. Rothschild & Keith McKenna, *Dealing with Accountants and Auditors: Avoiding Sanctions in Complex Cases*, 64 DEF. COUNS. J. 401 (1997) (discussing discovery requests and sanctions); Michael J. Sharp & Abraham M. Stanger, *Audit-Inquiry Responses in the Arena of Discovery: Protected by the Work-Product Doctrine*, 56 BUS. LAW. 183 (2000) (arguing that courts should not give adversaries access to audit inquiry responses and underlying documentation); Timothy M. Sukel & Mike F. Pipkin, *Discovery and Admissibility of Reserves*, 34 TORT & INS. L.J. 191 (1998) (addressing insurance reserves); Melissa D. Shalit, Note, *Audit Inquiry Letters and Discovery: Protection Based on Compulsion*, 15 CARDOZO L. REV. 1263 (1994) (arguing that the work product doctrine probably does not protect audit inquiry letters from discovery unless the enterprise can successfully assert that compulsion forced disclosure).

regarding litigation contingencies that opposing counsel might use in the underlying lawsuit, including a summary of the information generated for a business enterprise's auditors during the course of a financial statement audit.

Part III describes three important developments that have occurred since the 1975 accord: the enhanced disclosure rules in Management's Discussion and Analysis, the Supreme Court's decision in *United States v. Arthur Young & Co.*, which held that the Internal Revenue Service ("IRS") could summon tax accrual papers that the auditing firm had prepared to evaluate Amerada Hess Corp.'s reserves for contingent tax liabilities, and the Tax Reform Act of 1984, which added the "economic performance" requirement to § 461(h) of the Internal Revenue Code. Collectively, these developments have significantly changed the legal landscape and created or confirmed opportunities for discovery. In particular, this part discusses the use of tax returns and revenue agent reports to obtain information about a particular litigation contingency.

Part IV discusses the legal standards applicable during the discovery process. Initially, this part analyzes the relevancy requirement in Rule 26(b)(1) of the Federal Rules of Civil Procedure as applied to information related to litigation contingencies. Next, this part discusses the applicability of the attorney-client and accountant-client privileges to information related to litigation reserves. Finally, this part analyzes the applicability of the work product protection under Federal Rule of Civil Procedure 26(b)(3), which may protect information related to litigation reserves and litigation contingencies from discovery under certain circumstances. As a whole, however, these analyses lead to the conclusion that a strong potential exists for obtaining this information related to litigation reserves and litigation contingencies through discovery.

Part V concludes that existing law often allows litigation opponents access to significant information about the evaluations of an enterprise and its auditor and attorneys about the enterprise's exposure in the litigation, potentially evidenced by amounts that the enterprise has already accrued as an expense under financial accounting rules. The Commentary that accompanied the ABA Statement of Policy explicitly states that the expectation that communications between lawyers and auditors in accordance with the Statement of Policy would not prove prejudicial to clients engaged in or facing adversary proceedings underlies the Policy. If developments were to occur to negate this expectation, the ABA Statement of Policy recognized that the American Bar Association may need to review and revise the Statement of Policy. This article calls for such a review. Pending that review, Part V also proposes a new rule of evidence that, similar to Rule 411 of the Federal Rules of Evidence on liability insurance, would allow the discovery of information about litigation reserves, but generally bar its admission into evidence at trial.

II. PROFESSIONAL STANDARDS AFFECTING LITIGATION RESERVES AND THE CORRESPONDING BOOKS AND RECORDS, ACCOMPANYING DOCUMENTATION, ENSUING WORKPAPERS, AND RELATED INFORMATION

The accounting, auditing, and legal professions have established rules and standards of practice regarding litigation contingencies. Various concerns underlie these rules and professional standards. As a starting point, enterprises provide financial statements to owners, creditors, potential investors and lenders, and government bodies to enable those users to reach rational investment, credit, and similar decisions. These users often want assurances that the financial statements contain fair and accurate representations about the enterprise's financial condition and operating results. In addition, the federal securities laws require publicly traded enterprises to file audited financial statements with the SEC. As a result, an independent auditor often examines an enterprise's financial statements to express an opinion as to whether the financial statements fairly present the enterprise's financial position and operating results in conformity with GAAP.²⁰ As explained below, GAAP often requires an enterprise to accrue, disclose, or both accrue and disclose contingent losses arising from potential and pending litigation.²¹ If an enterprise's financial statements do not comply with GAAP, the enterprise and its directors and officers could find themselves defending a lawsuit or administrative action alleging financial statement fraud or securities fraud.²²

²⁰ The term "generally accepted accounting principles," often abbreviated "GAAP," refers to the "rules" governing the compilation of accounting data into financial statements and the form and content of those statements. Although Congress has given the SEC the legal authority to set accounting principles for those enterprises subject to its jurisdiction, the SEC has generally deferred to the private sector's official standards-setter, currently the Financial Accounting Standards Board. See HERWITZ & BARRETT, *supra* note *, at 144-45.

²¹ See *infra* notes 25-62 and accompanying text.

²² See, e.g., *In re Lee Pharm.*, Accounting and Auditing Enforcement Release No. 1023, [1995-1998 Accounting and Auditing Enforcement Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,538 (1998) (determining that certain environmental liabilities satisfied the disclosure requirements under GAAP and that non-disclosure rendered the registrant's financial statements materially misleading in administrative proceeding against registrant and certain officers and directors for failing to disclose the liabilities in the financial statements); *In re Corning, Inc. Sec. Litig.*, No. 92 Civ. 345 (TPG), 1997 WL 235122 (S.D.N.Y. May 7, 1997) (concluding that the consolidated and amended class action complaint sufficiently alleged that Corning's consolidated financial statements and periodic reports failed to reveal information about potential liabilities that a subsidiary, Dow Corning Corp., may have incurred in manufacturing and selling breast implants to approximately 800,000 women); *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1248 (N.D. Ill. 1997) (denying defendants' motion to dismiss a complaint alleging that the defendant company and executive officers failed to follow GAAP in reporting credit losses from automobile and retail installment sales contracts with

In an audit, the auditor seeks to gather evidence about the various representations that management has asserted in the financial statements regarding the enterprise's assets and liabilities at a specific date and transactions during a particular accounting period. In that way, auditors seek to ensure the reliability and credibility of financial statements for the various users. In particular, an auditor must use reasonable efforts to determine whether any material unrecorded or undisclosed liabilities exist. In every audit engagement, therefore, the auditor must identify and evaluate both actual liabilities and any possible losses arising from potential and pending litigation, claims, assessments, and other uncertainties (collectively, "loss contingencies") in an effort to reach reasonable assurance that the financial statements include all material liabilities and appropriately disclose any contingencies. If the auditor issues an unqualified opinion with respect to financial statements that do not appropriately treat loss contingencies, the auditor, as well as the enterprise, can face staggering legal liability.²³ Such potential liability, plus a desire to maintain their professional reputations, motivates auditors to gather as much information and evidence as possible about loss contingencies.

In every audit, the auditor asks the enterprise's management both to describe and evaluate various contingencies, including litigation contingencies, and to provide written assurance that the financial statements properly treat all loss contingencies. The auditor also seeks to obtain corroborating information from the enterprise's attorneys about contingent liabilities related to actual or possible lawsuits, claims, and assessments. In this latter regard, the auditor typically asks the enterprise's management to send an "audit inquiry letter" to outside counsel requesting that counsel provide information and confirm certain understandings regarding the enterprise's litigation contingencies.

Lawyers must exercise great care in responding to these audit inquiry letters. If an enterprise's lawyers fail or refuse to reply to these inquiries, presumably under some theory of confidentiality arising from the attorney-client privilege, the auditor may qualify the audit opinion. In other circumstances, the auditor may

"sub-prime" consumers, thereby overstating earnings and artificially inflating stock prices); *see also* SEC v. Trans Energy, Inc., No. 1-01-CV-02060, 2002 SEC LEXIS 465 (D.D.C. Feb. 27, 2002) (entering permanent injunction against registrant and two officers and imposing civil penalties against the officers for failing to disclose the existence of material lawsuits that resulted in over \$1 million in consent judgments against the company in its 1998 through 2000 SEC filings).

²³ *See, e.g.,* Endo v. Albertine, 863 F. Supp. 708, 713 (N.D. Ill. 1994) (denying motions for summary judgment by issuer and auditor in class action presenting claims for alleged failure to disclose material facts regarding contingent tax deficiencies exceeding \$100 million and environmental liabilities of more than \$60 million). Although arising and decided before Congress enacted the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, that legislation should not change the potential liability involved in such circumstances.

issue an adverse opinion or disclaim an opinion. Any report other than an unqualified opinion can adversely affect the enterprise's ability to attract capital, borrow funds, or even to continue in business. At the same time, a lawyer may not disclose confidential information, including a client's litigating position, to the auditor without the client's consent. If the enterprise authorizes the lawyer to disclose information to the auditor, lest the auditor refuse to render an unqualified opinion, at a minimum the enterprise waives the attorney-client privilege as to any information disclosed.²⁴

In an effort to balance the conflicting interests that exist under these circumstances, the legal and accounting professions reached a 1975 accord, sometimes referred to as "The Treaty," which ultimately led to the financial accounting rules set forth in SFAS No. 5, the auditing standards in SAS No. 12, and the ABA's Statement of Policy.

A. The Financial Accounting Rules and Resulting Documentation

SFAS No. 5 creates a framework for analyzing accounting issues involving loss contingencies, but generally allows an enterprise's management to exercise considerable discretion in determining whether to accrue and how to disclose a loss contingency. Under the financial accounting rules, loss contingencies include pending or threatened litigation and actual or possible claims or assessments.²⁵ Because SFAS No. 5 gives management broad discretion, accounting for contingencies more closely resembles an art than a science. Depending upon the underlying circumstances, an enterprise's management may have to choose among both fully accruing and disclosing the loss contingency, fully accruing but not disclosing, accruing in part and disclosing the rest, accruing in part but not disclosing the rest, or merely disclosing the contingency in the financial statements. On the other hand, if the contingency qualifies as sufficiently unlikely to occur, the enterprise need not even disclose the matter.

SFAS No. 5 defines a "loss contingency" as "an existing condition, situation, or set of circumstances involving uncertainty as to possible [loss] to an enterprise

²⁴ Although numerous states have enacted an accountant-client privilege, the common law did not recognize such a privilege, and no such privilege generally exists under federal law. Because the lawyer prepares the response in connection with an annual audit that would occur even without the underlying litigation, the response arguably represents an "ordinary business record," which does not qualify for protection from discovery or use as evidence at trial under the work product doctrine. *See infra* notes 265–320 and accompanying text.

²⁵ Other examples of loss contingencies include the collectibility of receivables that arise from credit sales, loans, or other transactions; obligations related to product warranties and product defects; threats of expropriation; and guarantees of another's indebtedness. ACCOUNTING FOR CONTINGENCIES, Statement of Financial Accounting Standards No. 5, ¶ 4 (Financial Accounting Standards Bd. 1975).

that will ultimately be resolved when one or more future events occur or fail to occur.”²⁶ The uncertainty’s resolution may confirm that at least one of the enterprise’s assets has suffered an impairment or that the enterprise has incurred at least one liability. Either of these situations would require the enterprise to record a corresponding loss or expense as a charge against income. Together with other accounting pronouncements, SFAS No. 5 provides separate, but presumably similar, rules governing financial accounting and reporting for (i) pending litigation, claims, and assessments and (ii) unasserted claims and assessments. Although information regarding litigation reserves sometimes appears in the financial statements or notes to those statements, more commonly an attorney interested in obtaining such information must carefully review the enterprise’s books and records, including the chart of accounts, general ledger, general journal, and supporting documentation.

1. Pending Litigation, Claims, and Assessments

An enterprise must assess various factors in determining the proper financial accounting treatment of any loss contingency. For pending litigation, claims, and assessments, the most important factors include materiality; the accounting period in which the underlying event that gave rise to the litigation, claim, or assessment occurred; the likelihood of an unfavorable outcome to the enterprise; and the enterprise’s ability to reasonably estimate any likely loss.²⁷ For unasserted claims, a business must first assess the probability of assertion. If the enterprise concludes that the circumstances suggest that the potentially adverse party will not assert the claim, SFAS No. 5 does not require accrual or disclosure. By comparison, if assertion seems probable, the enterprise must proceed in exactly the same manner as if the potentially adverse party had already asserted the claim.²⁸

a. Factors Affecting Financial Accounting Treatment

For pending litigation and existing claims or assessments, SFAS No. 5 requires an enterprise to consider four factors in determining the proper financial accounting treatment: (1) the materiality of the litigation, claims, or assessments to the enterprise’s financial condition and operating results; (2) the period in

²⁶ *Id.* ¶ 1 (footnote omitted). Similarly, the pronouncement defines a “gain contingency” as “an existing condition, situation, or set of circumstances involving uncertainty as to possible gain . . . to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.” *Id.*

²⁷ See *infra* notes 29–48 and accompanying text.

²⁸ See *infra* notes 61–62 and accompanying text.

which the underlying cause that gave rise to the litigation, claim, or assessment occurred; (3) the likelihood of an unfavorable outcome to the enterprise; and (4) the enterprise's ability to estimate reasonably any potential loss.

i. *Materiality*

As an initial matter, an enterprise should consider materiality because SFAS No. 5 does not apply to immaterial items.²⁹ About five years after issuing SFAS No. 5, the Financial Accounting Standards Board described "materiality" as "[t]he magnitude of an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."³⁰ As a general rule, accountants have historically treated any amount which does not exceed five percent of income before taxes or owners' equity as immaterial. By comparison, accountants have typically considered any item which exceeds ten percent of income before taxes or owners' equity to be material.³¹

ii. *Underlying Event*

Under SFAS No. 5, an enterprise can accrue an amount related to a loss contingency only if information available prior to the issuance of financial statements indicates that the underlying event or events that gave rise to the contingency had impaired an asset or created a liability *at the date of the financial statements*.³² As a result, an enterprise cannot accrue any amount for a loss contingency when the underlying event or condition occurred after the date of the financial statements, but before the enterprise issues the financial statements. For example, SFAS No. 5 would preclude an accrual for a lawsuit seeking damages resulting from an accident that occurred after the date of the financial statements.³³ As discussed below, however, SFAS No. 5 may require the enterprise to disclose the existence of a potential loss incurred after the date

²⁹ ACCOUNTING FOR CONTINGENCIES, *supra* note 25, in the note following ¶ 20.

³⁰ QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFO., Statement of Financial Accounting Concepts No. 2, at xv (Financial Accounting Standards Bd. 1980).

³¹ See LuAnn Bean & Deborah W. Thomas, *The Development of the Judicial Definition of Materiality*, 17 ACCT. HISTORIANS J. 113, 114 (1990); see also Charles Johnson et al., *Materiality for Extraordinary Items*, NAT'L PUB. ACCT., Dec. 1990, at 42, 43 (listing other mathematical guidelines for average net income, total revenues, total assets, and owners' equity). The legal standard for materiality, however, may differ from the financial accounting standard. See *infra* notes 170–73 and accompanying text.

³² ACCOUNTING FOR CONTINGENCIES, *supra* note 25, ¶ 34.

³³ *Id.*

of the financial statements to keep the financial statements from being misleading.³⁴

By comparison, SFAS No. 5 may require an enterprise to accrue an amount related to a loss contingency involving a lawsuit, claim, or assessment when the underlying cause occurred on or before the date of the enterprise's financial statements, even though the enterprise does not learn about "the existence or possibility of the lawsuit, claim, or assessment until after the date of the financial statements."³⁵ Because the underlying event or condition occurred on or before the date of the financial statements, any information available prior to the issuance of the financial statements can affect the proper accounting treatment. Therefore, subsequent events and developments can change the appropriate accounting and reporting until the enterprise has issued the financial statements.

iii. *Likelihood of an Unfavorable Outcome*

When a loss contingency exists, SFAS No. 5 divides the likelihood that some future event or events will confirm a loss into three categories: probable, reasonably possible, and remote. SFAS No. 5 describes the likelihood of an unfavorable outcome as "probable" when "[t]he future event or events are likely to occur."³⁶ Although SFAS No. 5 itself does not provide any additional guidance about what the words "probable" or "likely" mean, the related explanation states that the word "probable" does not infer "virtual certainty."³⁷

³⁴ *Id.*; see *infra* note 60 and accompanying text.

³⁵ ACCOUNTING FOR CONTINGENCIES, *supra* note 25, ¶ 35.

³⁶ *Id.* ¶ 3a.

³⁷ *Id.* ¶ 84. Subsequent accounting pronouncements offer only slightly more insight about when the chances of an unfavorable outcome fall within the "probable" area. In 1985, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements ("Concepts Statement No. 6"), which explicitly draws a distinction between the "usual general meaning" of the word "probable" and its use in "a specific accounting or technical sense (such as that in [SFAS No. 5])." ELEMENTS OF FINANCIAL STATEMENTS: A REPLACEMENT OF FASB CONCEPTS STATEMENT NO. 3 (INCORPORATING AN AMENDMENT OF FASB CONCEPTS STATEMENT NO. 2), Statement of Financial Accounting Concepts No. 6 ¶¶ 25 n.18, 35 n.21 (Financial Accounting Standards Bd. 1985). In two footnotes, Concepts Statement No. 6 describes the "usual general meaning" as "that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain or proved," but does not further explain the meaning of the word "probable" in SFAS No. 5. *Id.* (citing WEBSTER'S NEW WORLD DICTIONARY OF THE AMERICAN LANGUAGE 1132 (2d college ed. 1982)). In the explanation to Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes, which the FASB issued in 1992, the Board refers to the footnotes in Concepts Statement No. 6 that discuss the word "probable." ACCOUNTING FOR INCOME TAXES, Statement of Financial Accounting Standards No. 109, ¶ 94 (Financial Accounting Standards Bd. 1992). In addition, the Board specifically

Elsewhere, the accompanying explanation refers to this requirement as “not so past-oriented that accrual of a loss must await the occurrence of the confirming future event, for example, final adjudication or settlement of a lawsuit.”³⁸

Given this ambiguity, readers can easily assign different meanings to the terms “probable” or “likely to occur.” A lawyer, for example, might describe the terms as meaning “more likely than not” or “anything greater than fifty percent.” With no explanation, one commentator describes the expression as “somewhat more likely than 50 percent, say 60 to 70 percent.”³⁹ In contrast, a leading accounting text describes the phrase as “at least 80 percent.”⁴⁰

At the other end of the spectrum, SFAS No. 5 describes the likelihood of an unfavorable outcome as “remote” when “[t]he chance of the future event or events occurring is slight.”⁴¹ As the third and final alternative, SFAS No. 5 designates the likelihood of an unfavorable outcome as “reasonably possible,” which the pronouncement describes as “more than remote but less than likely.”⁴² Most commentators, therefore, believe that “reasonably possible” serves as a default category.

SFAS No. 5 further states that an enterprise should consider factors, such as the progress of the case, opinion of legal counsel, prior experience of the enterprise or other enterprises in similar matters, and management’s intended response, when assessing the likelihood of an unfavorable outcome.⁴³ When assessing the progress of the case, an enterprise should assess the stage of the claim or litigation, such as discovery or trial. In considering the opinion of legal counsel, SFAS No. 5 explicitly states that even if counsel cannot give a favorable opinion, the business may still not have satisfied the necessary conditions for loss accrual. With regard to management’s intended response, management may plan to contest the case vigorously or to try to settle.

distinguishes “probable” and “more likely than not.” *Id.* ¶ 93. For purposes of measuring a deferred tax asset, the Board expressly rejected “probable” within the meaning of SFAS No. 5 as the applicable criterion. Instead, the Board selected the phrase “more likely than not” as the criterion and explicitly stated that those words establish “a level of likelihood that is more than 50 percent.” *Id.* ¶¶ 96, 97.

³⁸ ACCOUNTING FOR CONTINGENCIES, *supra* note 25, ¶ 68.

³⁹ GEORGE MUNDSTOCK, A FINANCE APPROACH TO ACCOUNTING FOR LAWYERS 149 n.6 (1999). Because SFAS uses the term “probable” to refer to both the likelihood of assertion and the likelihood of an unfavorable outcome, I have long suggested to my students that SFAS No. 5 offers some support for treating “probable” as approximately 70.7%. *See infra* note 62.

⁴⁰ CLYDE P. STICKNEY & ROMAN L. WEIL, FINANCIAL ACCOUNTING: AN INTRODUCTION TO CONCEPTS, METHODS, AND USES 520 n.4 (8th ed. 1997) (“[M]ost accountants and auditors appear to use *probable* to mean 80 to 85 percent or larger.”).

⁴¹ ACCOUNTING FOR CONTINGENCIES, *supra* note 25, ¶ 3c.

⁴² *Id.* ¶ 3b.

⁴³ *Id.* ¶ 36.

iv. Ability to Reasonably Estimate the Potential Loss

If an enterprise determines that circumstances suggest that the chance that future events will confirm a loss qualifies as probable and the enterprise can reasonably estimate the loss, the enterprise must accrue a loss in that amount. In many situations where an enterprise has probably incurred a loss, however, the enterprise cannot reasonably estimate any single loss amount, but can only identify a wide range of possible losses. When some amount within a range seems like a better estimate than any other amount within the range, an enterprise should accrue that amount.⁴⁴ If the enterprise cannot determine a best estimate within the range, the enterprise should accrue the minimum amount in the range and disclose any reasonably possible additional loss that satisfies the other requirements in SFAS No. 5.⁴⁵ When the enterprise cannot reasonably estimate the loss, SFAS No. 5 requires disclosure, rather than accrual, whenever the likelihood of occurrence qualifies as at least “reasonably possible.”⁴⁶ The disclosure must indicate the nature of the contingency and must either (i) give an estimate of the potential loss or range of loss or (ii) state that the enterprise cannot make such an estimate.⁴⁷ The requirement that an enterprise cannot accrue a loss until the enterprise can reasonably estimate the amount seeks to preclude enterprises from accruing amounts so uncertain as to impair the financial statements’ integrity.⁴⁸

b. Financial Accounting Alternatives

Depending upon the underlying circumstances, an enterprise may have to (i) both accrue and disclose a loss, (ii) accrue but not disclose the loss, (iii) accrue part of a potential loss and disclose the remaining contingency, or (iv) simply disclose the contingency. If a contingency qualifies as sufficiently unlikely to occur, however, the enterprise need not even disclose the matter.

i. Accrual of Loss Contingencies

Paragraph eight of SFAS No. 5 both requires and allows an enterprise to accrue an estimated loss only if both: (1) information available prior to the

⁴⁴ REASONABLE ESTIMATION OF THE AMOUNT OF A LOSS: AN INTERPRETATION OF FASB STATEMENT NO. 5, FASB Interpretation No. 14, ¶ 3 (Financial Accounting Standards Bd. 1976).

⁴⁵ *Id.*

⁴⁶ ACCOUNTING FOR CONTINGENCIES, *supra* note 25, ¶ 10.

⁴⁷ *Id.*

⁴⁸ *Id.* ¶ 59.

issuance of financial statements indicates that the enterprise probably, or at least more likely than not, incurred a liability or suffered the impairment of an asset before the date of the financial statements; and (2) the enterprise can reasonably estimate the loss.⁴⁹ To reiterate, a business must satisfy both conditions of paragraph eight to accrue a loss contingency. By imposing these requirements, SFAS No. 5 seeks to ensure that any accrued losses relate to the current or a prior period. If the circumstances do not indicate that the enterprise has at least more likely than not incurred a loss and the enterprise cannot reasonably estimate the loss, the potential loss relates to a future period.⁵⁰ In addition, paragraph nine of SFAS No. 5 may require the enterprise to disclose the nature of the accrual, and perhaps its amount, to keep the financial statements from becoming misleading.⁵¹

When read literally SFAS No. 5 would arguably also preclude an enterprise, such as Merrill Lynch or Disney, from accruing an amount which reflects the expected loss. For example, assume a defendant foresees a twenty percent chance of losing the lawsuit, but an eighty percent chance of winning. If the defendant loses, the defendant expects a fifty percent chance of a \$500 million verdict and a fifty percent chance of a \$2 billion verdict. As a result, the defendant calculates an expected \$250 million liability,⁵² even though the defendant does not anticipate any scenario in which the actual loss would equal that amount. Because the defendant predicts an eighty percent chance of success, the likelihood of loss presumably falls into the reasonably possible category and SFAS No. 5 arguably precludes the defendant from accruing any amount.⁵³

ii. *Disclosure of Loss Contingencies*

SFAS No. 5 precludes an enterprise from accruing a litigation contingency unless both the loss qualifies as probable and the enterprise can reasonably estimate the loss. Absent accrual, the enterprise's income statement and balance sheet would not reflect the loss contingency. Several different sets of circumstances, however, require disclosure of a litigation contingency. First, if

⁴⁹ *Id.* ¶ 8.

⁵⁰ *Id.* ¶ 59.

⁵¹ *Id.* ¶ 9.

⁵² With a twenty percent chance of losing, the defendant faces a ten percent chance (fifty percent of twenty percent) of losing \$500 million and a ten percent chance of losing \$2 billion. As a result, the total estimated loss equals \$250 million $[(.10 \times \$500 \text{ million}) + (.10 \times \$2 \text{ billion})]$. An alternative reading of SFAS No. 5 would conclude that under these circumstances the enterprise justifiably expects to incur a \$250 million loss, which would satisfy both the requirements that the loss qualifies as "probable" and that the enterprise can reasonably estimate that loss.

⁵³ See *supra* notes 36–43 and accompanying text.

management assesses the chance of an unfavorable outcome as reasonably possible, the enterprise must disclose the litigation contingency.⁵⁴ Similarly, if exposure to a loss exists in excess of the amount accrued, the enterprise must disclose the potential unaccrued loss when at least a reasonable possibility exists that the enterprise has incurred such a loss.⁵⁵ Third, when management concludes that the chance of an unfavorable outcome qualifies as probable, but cannot determine a reasonable estimate of the loss amount, the enterprise must again disclose the contingency.⁵⁶ In addition, an enterprise must disclose any contingent obligations arising from guarantees.⁵⁷ Any disclosures shall indicate:

⁵⁴ *Id.*

⁵⁵ See, e.g., *SEC v. Steadman*, 967 F.2d 636, 645 (D.C. Cir. 1992) (upholding the district court's conclusion that SFAS No. 5 required various mutual funds to include a footnote in their financial statements disclosing contingent liabilities for not registering under state blue sky laws as long as a reasonable possibility existed that the liabilities would materialize).

⁵⁶ ACCOUNTING FOR CONTINGENCIES, *supra* note 25, ¶ 10.

⁵⁷ *Id.* ¶ 12. Separate from loss contingencies from pending or unasserted litigation, claims, or assessments, SFAS No. 5 also provides separate accounting rules for financial guarantees. Such guarantees include: "(a) guarantees of indebtedness of others, (b) obligations of commercial banks under 'standby letters of credit,' and (c) guarantees to repurchase receivables (or, in some cases, to repurchase the related property) that have been sold or otherwise assigned." *Id.* SFAS No. 5 requires an enterprise that has any such guarantee to disclose the guarantee in its financial statements, even when the enterprise assesses the possibility of loss as only remote. *Id.* Enterprises should disclose "the nature and amount of the guarantee," and, if the enterprise has the right to proceed against a third party, the value of such recovery, if estimable. *Id.* Like other contingencies, however, paragraph twelve does not apply to immaterial amounts. When an enterprise determines that a financial guarantee will not materially affect its financial position, SFAS No. 5 does not require that the enterprise disclose the guarantee in the notes to the financial statements. See *id.*

The Enron crisis illustrates the importance of disclosing financial guarantees in the notes to the financial statements. When various Enron affiliates, commonly referred to as special purpose entities (SPEs), that Enron formed to keep debt off its books sought credit, the lenders often required that Enron guarantee the debt. On several occasions, Enron guaranteed amounts that various SPEs borrowed by promising to pay cash or to issue additional common shares to repay the debt, if the market price of Enron's common shares dropped under a certain amount or if Enron's bond rating fell below investment grade. While the notes to Enron's financial statements disclosed guarantees of the indebtedness of others, Enron did not mention that its potential liability on those guarantees, which shared common debt repayment triggers, totaled \$4 billion. See William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002).

In May 2002, the FASB issued a proposed interpretation for accounting for and disclosing financial guarantees. GUARANTOR'S ACCOUNTING AND DISCLOSURE REQUIREMENTS FOR GUARANTEES, INCLUDING INDIRECT GUARANTEES OF INDEBTEDNESS OF OTHERS: AN INTERPRETATION OF FASB STATEMENTS NO. 5, 57 AND 107, Financial Accounting Series Exposure Draft (Financial Accounting Standards Bd., Proposed Interpretation, May 22, 2002), http://www.fasb.org/draft/ed_prop_interp_guarantees.pdf. In addition to the nature and amount

(1) the nature of the claim and (2) either (a) an estimate of possible loss or range of possible loss or (b) a statement that the business cannot make a reasonable estimate. In these circumstances, an attorney can usually find any disclosures about any material contingencies in the notes to the financial statements, typically in a note labeled "Commitments and Contingencies."⁵⁸

The following chart summarizes the rules in SFAS No. 5 for treating material, asserted claims that arise from underlying events that occurred before the date of the financial statements:

ACCOUNTING TREATMENT FOR ASSERTED CLAIMS			
		Ability to Reasonably Estimate the Potential Loss	
		Reasonable Estimate	No Reasonable Estimate
Likelihood of an Unfavorable Outcome	Probable—likely to occur	Accrue and, if necessary, disclose to avoid misleading financial statements	Disclose contingency and range of possible loss or state that no reasonable estimate possible
	Reasonably possible—less than probable but more than remote	Disclose contingency and estimated amount of possible loss	Disclose contingency and range of possible loss or state that no reasonable estimate possible
	Remote—slight	Neither accrue nor disclose, unless guarantee	Neither accrue nor disclose, unless guarantee

of the guarantee and any potential recovery, the proposed interpretation requires a guarantor to disclose "the maximum potential amount of future payments under the guarantee" and "the carrying amount of the liability, if any." *Id.* at ii, 6. Regarding the disclosure of any potential recovery, the proposed interpretation does not limit such disclosure to only estimable amounts. *Id.* Although SFAS No. 5 requires the guarantor to disclose potential recovery amounts, the proposed interpretation states that "[b]ecause entities generally disclose *only the nature and amount of guarantees*, the disclosures under current practice do not provide the same level of useful information as would be required under this proposed Interpretation." *Id.* at ii (emphasis added). The proposed interpretation also requires a guarantor to recognize a liability at the inception of the guarantee for the fair value of all of the obligations it undertook when it issued the guarantee. *Id.* at ii, 6, 8.

⁵⁸ See, e.g., 1994 MERRILL LYNCH ANNUAL REPORT, *supra* note 5, at 44–45.

As discussed above, an enterprise may have to disclose information about an accrual to prevent the financial statements from becoming misleading.⁵⁹ Finally, an enterprise must also disclose information about contingencies from so-called “subsequent events” or underlying events that occurred after the date of the financial statements, but before the enterprise issued the financial statements and which could have a material effect on the financials.⁶⁰

2. *Unasserted Claims*

For unasserted claims, a business must first assess the probability of assertion. If the enterprise concludes that the circumstances suggest that the potentially adverse party will not assert the claim, SFAS No. 5 does not require accrual or disclosure. By comparison, if assertion seems probable, the enterprise must proceed in exactly the same manner as if the potentially adverse party had already asserted the claim.⁶¹

Weird outcomes can seemingly result from applying the rules regarding unasserted claims, especially if an enterprise interprets “probable” as meaning “more likely than not.” Assume that an enterprise assigns a 51% chance to the probability that the claimant will assert a \$100 million claim and a 51% chance to an unfavorable outcome on the full claim. Under SFAS No. 5 and those circumstances, the enterprise must potentially accrue, and perhaps disclose, a \$100 million loss even though the overall chance that the enterprise will incur the loss equals 26.01% (51% times 51%).⁶²

⁵⁹ See *supra* note 51 and accompanying text.

⁶⁰ ACCOUNTING FOR CONTINGENCIES, *supra* note 25, ¶ 11.

⁶¹ See *supra* notes 49–60 and accompanying text.

⁶² To avoid this problem, and at the risk of suggesting that either a lawyer, an accountant, or any other mortal could precisely quantify such an amount, I have argued that SFAS No. 5 implicitly treats the term “probable” as meaning at least the square root of any amount greater than 50%, or no less than approximately 70.711% ($.70711 \times .70711 = .5000045521$). Based upon SFAS No. 5’s articulated interest in preserving the integrity of financial statements, I would argue that, notwithstanding the promulgation’s ambiguity, it does not contemplate that an enterprise should accrue a loss to reflect an unasserted claim unless the likelihood of an unfavorable outcome at least exceeds 50%. Before an enterprise can accrue a loss related to an unasserted claim, the enterprise must reach two separate conclusions. First, the enterprise must determine the degree of probability that the aggrieved party will assert the claim. Only if the enterprise considers assertion “probable” does the enterprise proceed to the second determination, where the enterprise must assess the possibility of an unfavorable outcome. In that regard, paragraph thirty-eight states:

[A] judgment must first be made as to whether the assertion of a claim is probable. If the judgment is that assertion is not probable, no accrual or disclosure would be required. On the other hand, if the judgment is that assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. If an unfavorable

3. *Financial Accounting Information and Documentation Related to Loss Contingencies*

Reading an enterprise's financial statements typically will not reveal whether the enterprise has established a litigation reserve related to an underlying lawsuit. In most cases, a lawyer seeking to find litigation reserves must carefully review the enterprise's books and records. Assuming that the enterprise complies with GAAP and maintains adequate and accurate books and records, the enterprise's general journal, general ledger, and supporting documentation will indicate when an enterprise has created a litigation reserve related to particular litigation and the amount of that reserve.

When reviewing a litigation opponent's financial statements, a number of specific areas within those documents may provide clues regarding management's determinations regarding litigation contingencies. In some circumstances, SFAS No. 5 requires an enterprise to disclose an accrual to prevent the financial statements from becoming misleading.⁶³ In such event, disclosure will appear either on the face of the financial statements themselves or, more likely, in the notes to the financial statements. As a result, an attorney might sometimes identify the establishment of a litigation reserve in the footnotes to the financial statements. For example, the notes to the consolidated financial statements of Wabash National Corp., a company listed on the New York Stock Exchange, for the year ended December 31, 1998 provided, in pertinent part, the following information about a tax assessment:

On December 24, 1998, the Company received notice from the Internal Revenue Service that it intends to assess federal excise tax on certain used trailers restored by the Company during 1996 and 1997. The Company strongly disagrees with and intends to vigorously contest the assessment. In applying generally accepted accounting principles, the Company recorded a \$4.6 million accrual in 1998 for this loss contingency that is reflected in Other, net in the accompanying Consolidated Statements of Income.⁶⁴

outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph 8.

ACCOUNTING FOR CONTINGENCIES, *supra* note 25, ¶ 38. Because SFAS No. 5 uses the term "probable" to refer to both the likelihood of assertion and the likelihood of an unfavorable outcome, and weird outcomes result if the circumstances suggest a 50% or less chance of ultimate liability, the term "probable" must mean something around at least 70.711%.

⁶³ ACCOUNTING FOR CONTINGENCIES, *supra* note 25, ¶ 9; *see also supra* note 51 and accompanying text.

⁶⁴ WABASH NAT'L CORP., FORM 10-K, ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934, at 41 (for the fiscal year ended Dec. 31, 1998) (filed Mar. 31, 1999).

Because enterprises almost certainly do not want to reveal the amount of a litigation reserve to any opponent in the underlying litigation, and any particular litigation contingency rarely involves a large enough dollar amount in relation to the enterprise's assets, other liabilities, owners' equity, or revenues, the financial statements only rarely contain a specific line-item for a particular litigation contingency.⁶⁵ To identify a litigation reserve, if any, related to an underlying lawsuit, an attorney must request information about any litigation contingencies during discovery by submitting interrogatories and related requests for the production of documents or by deposing one or more members of the enterprise's management that oversees financial accounting and reporting. In either alternative, the attorney may need to work backwards through the double-entry bookkeeping system that most enterprises use to maintain financial accounting records and to prepare financial statements.⁶⁶

The style and form of an enterprise's financial accounting system will vary from firm to firm. In general, however, the financial statements represent the "ends" in a process that accountants refer to as *double-entry bookkeeping*. As the "means" in the process, business enterprises use journals, ledgers, accounts, debits, credits, charts of accounts, trial balances, and worksheets. These accounting records and concepts underlie the financial statements.

Under double-entry bookkeeping, the individual who performs the bookkeeping function for the enterprise first records transactions chronologically in a separate book, usually referred to as the *journal*. Enterprises may use various kinds of journals, but every business will use a *general journal*. An enterprise may also create a journal to record transactions in various functions, such as a sales journal, a purchases journal, a cash receipts journal, or a cash disbursements journal. The general journal typically contains five columns for the date, the accounts involved and any explanation of the transaction, a cross-reference for the account number to which the bookkeeper transferred the amount in the journal entry, and separate columns for debits and credits. The terms "debit" and "credit" simply refer to left-hand and right-hand entries, respectively. Debits reflect increases in assets or decreases in either liabilities or

⁶⁵ Generally, the balance sheet will reflect any litigation reserves in a line item labeled something like "Accrued Liabilities," "Other Current Liabilities," or "Other Liabilities." If the enterprise expects to pay the liability within one year of the date of the balance sheet, the line item would appear under current liabilities. Similarly, the income statement will usually reflect the corresponding expense or loss in "General and Administrative" expenses. Finally, even though an increase in a litigation reserve does not require a cash outlay, because most enterprises use the indirect method to report cash flows from operating activities, the enterprise's statement of cash flows would typically show only the net increase or decrease in payables, including any litigation reserves.

⁶⁶ See generally HERWITZ & BARRETT, *supra* note *, at 14-38, 112-14.

equity. Credits record decreases in assets or increases in either liabilities or equity.

Today, most enterprises use computers to keep their journals, but the fundamental concepts remain the same. After an event or transaction has been recorded in the journal, the entries are then entered in the appropriate accounts, a process known as *posting* from the journal to the *ledger*. Accountants refer to the *general ledger* as the collection of all the asset, liability, equity, revenue, gain, expense, and loss accounts that an enterprise maintains. The ledger, therefore, stores in one place all the information about changes in specific account balances, including any litigation reserves. Again, businesses often keep various kinds of ledgers, but every business will use a general ledger. An enterprise may also keep subledgers when it needs to keep very detailed records. For example, an enterprise may use an accounts receivable subledger to record the individual amounts that each customer owes to the enterprise. The accounts receivable account in the general ledger would keep track of the total amount owed to the firm by all its customers. The sum of the subsidiary accounts in the subledger must equal the balance in the accounts receivable account in the general ledger.

Until computers took over most bookkeeping, enterprises often used a looseleaf binder or card file for each ledger, with each account kept on a separate sheet or card. Even today, however, most enterprises number each account for identification purposes and usually place the accounts in the general ledger in balance sheet order, starting with assets. Accounts for liabilities, equity, revenues and gains, and expenses and losses usually follow, in that order. Most enterprises have prepared a *chart of accounts*, which lists each account and the account number which identifies the account's location in the ledger. As with journals, most enterprises today use computerized ledgers, but the underlying concepts still remain the same.

During the *closing process*, the enterprise's bookkeeping system first determines the balance in each account by netting one side against the other. At this point, many enterprises will generate a trial balance. The trial balance lists all accounts in the general ledger and their balances to confirm that debits equal credits. Next, the bookkeeper will prepare any necessary adjusting entries, including entries to accrue any loss contingencies, in an effort to allocate revenues and expenses to accounting periods, regardless of when the cash receipts or expenditures actually occur. After posting any adjusting entries to the ledger, many enterprises prepare an adjusted trial balance, which lists all accounts in the general ledger and their balances after the enterprise has posted any adjusting entries.

Next, the bookkeeper prepares closing journal entries which transfer the balances in the revenue, gain, expense, and loss accounts to a clearinghouse Profit and Loss account and posts those entries to the ledger. Then, a final closing entry transfers the balance in the Profit and Loss account to the

appropriate equity account. Again, the enterprise's accounting function posts this entry to the ledger. Only as the final step in the process, does the enterprise prepare financial statements.

Especially when deposing someone from the enterprise's management or accounting department, a lawyer may have to work backwards through the bookkeeping process. As a first step, however, the attorney should try to obtain the enterprise's general ledger, adjusted trial balance for the most recent accounting period, and chart of accounts, or their equivalents. When trying to understand an enterprise's accounting records so as to find an expense arising from a litigation contingency, the knowledgeable attorney typically starts with the chart of accounts. By scanning the chart of accounts, the attorney may locate expenses related to a particular litigation contingency by looking for account names such as "Litigation Expense" or "Expected Loss from Litigation." Wherever possible, enterprises will try to bury expenses related to such expenses in other accounts, such as "Salaries and Wages" for employment discrimination costs or "Miscellaneous Expenses." In addition, the accounting literate attorney scans the chart of accounts for any "reserve" accounts by looking for account names for liabilities such as "Accrued Litigation Costs Payable," "Estimated Liability for Litigation," "Litigation Liabilities Payable," "Litigation Provision," "Litigation Reserve," "Provision for Litigation," and "Reserve for Litigation." In the absence of such liability account titles, an attorney may find hidden litigation reserves in more generally titled accounts such as "Accrued Liabilities," "Accrued Payables," "Miscellaneous Payables," and "Other Accrued Liabilities."

Once the attorney identifies a potentially relevant account, the attorney must often trace individual items in the account back to the appropriate journal entries. Once the attorney has found any journal entries related to a litigation reserve, the attorney should next ask to see the supporting documentation for those entries.

The style and form of the documentation that an enterprise generates regarding litigation losses and expenses varies from firm to firm. Every enterprise that prepares financial statements in accordance with GAAP, however, must consider, at least tacitly, the following factors, specified in SFAS No. 5, when evaluating the probability of an unfavorable outcome: (1) the nature of the litigation; (2) the progress of the case; (3) the opinions or views of legal counsel and other advisers; (4) the experience of the enterprise in similar cases; (5) the experience of other enterprises; and (6) any decision of the enterprise's management as to how it intends to respond to the litigation.⁶⁷ Although SFAS No. 5 refers to these factors as merely "among" those considerations that

⁶⁷ See ACCOUNTING FOR CONTINGENCIES, *supra* note 25, ¶ 36; see also *supra* note 43 and accompanying text.

management should evaluate,⁶⁸ functionally they represent a fairly exhaustive listing.

Management's consideration of the nature of the litigation seems intertwined with all five of the other factors. For example, after a district court denies the enterprise's motion to dismiss in a securities fraud cause of action, management might tend to expect to begin settlement negotiations in the near future. In those circumstances, consideration implicates the nature of the litigation, the progress of the case, and the enterprise's experience in similar cases.⁶⁹ Although management may rely on the views of legal counsel, the nature of the litigation may provide management with the information needed to reach a determination regarding the probability of a settlement. Management's consideration of the nature of the litigation may result in memoranda that discuss the litigation in comparison to similar lawsuits, whether based on the enterprise's own experience or the experiences of other enterprises.

The enterprise's experience with similar lawsuits, in particular, may also lead to extremely helpful documentation. All enterprises seek to reduce expenses, including attorney fees. As an enterprise's management experiences more and more lawsuits of a similar nature, either management or the accounting department may tend to rely less on legal counsel to make any financial reporting determinations. This tendency also may generate intra-office correspondence that would likely not enjoy either attorney-client privilege or work product protection. Such communications might reveal witnesses or facts not known to the claimant's attorney, or even management's opinions and conclusions regarding the enterprise's liability or the case's settlement value.

Cost-cutting considerations aside, most enterprises will continue to rely upon their legal counsel to develop opinions and conclusions regarding litigation contingencies. Management might request direct responses from the enterprise's in-house legal department or outside counsel, hold meetings with those attorneys, or simply rely on communications that the lawyers and management exchanged during the on-going litigation. To support an accrual or disclosure, the individuals responsible for SFAS No. 5 determinations, whether management or the enterprise's accounting personnel, might document and retain such communications in a file related to the financial statements. Many enterprises, in

⁶⁸ ACCOUNTING FOR CONTINGENCIES, *supra* note 25, ¶ 36.

⁶⁹ JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 976 (2d ed. 1997) (stating that "[i]t is generally believed that the defendants are more risk averse" and can "therefore be expected to favor . . . settlement, especially if it is significantly less than they risk losing through trial").

the ordinary course of business, will monitor ongoing litigation against the enterprise to ensure adequate litigation reserves to absorb expected losses.⁷⁰

Any time an enterprise needs audited financial statements, its financial statements must comply with GAAP. As such, the enterprise's balance sheet, income statement, statement of cash flows, and the notes to the financial statements must comply with SFAS No. 5. If an attorney can identify an expense arising from the litigation on the income statement, a litigation reserve on the balance sheet, or an adjustment on the statement of cash flows related to a litigation reserve, the attorney can conclude that management has determined that the chances of an unfavorable outcome in the lawsuit exceed fifty percent.⁷¹ In addition, the existence of expenses related to a litigation contingency also reveals that management has put at least an estimated value on the lawsuit.⁷² Even if the attorney can only identify a disclosure regarding a litigation contingency, the disclosure reveals that management has at least contemplated the probability of an unfavorable outcome and has likely generated some documentation to support its decision to disclose the litigation contingency.⁷³ Finally, an attorney who can find neither an accrual nor disclosure of a contingency related to the operative lawsuit still need not give up on pursuit of documentation related to the lawsuit. The lack of disclosure may mean simply that the lawsuit represents an immaterial item to the enterprise as a whole; alternatively, management might have knowledge of facts that, in its opinion, supports a conclusion of only a remote possibility that the enterprise will lose the lawsuit. In either case, either management or a third party, such as the outside auditor, may have generated useful documentation and information related to the lawsuit.

B. Auditing Standards and Related Documentation

While many small businesses do not require audited financial statements, many mid-sized and most larger businesses undergo annual audits. In particular, so-called *registrants*, specifically those companies whose shares are listed on a national securities exchange, such as the New York Stock Exchange or The Nasdaq Stock Market, Inc., or which meet certain tests relating to total assets and number of shareholders, must file audited financial statements with the SEC.⁷⁴ In

⁷⁰ See, e.g., *Simon v. G.D. Searle & Co.*, 816 F.2d 397, 400 (8th Cir. 1987) (regarding manufacturer that maintained a corporate risk management department that monitored product liability litigation to "keep track of, control, and anticipate the costs of . . . litigation").

⁷¹ See *supra* notes 39–40 and 49–51 and accompanying text.

⁷² See *supra* notes 44–45 and 49–51 and accompanying text.

⁷³ See *supra* notes 54–58 and 67–69 and accompanying text.

⁷⁴ Securities Exchange Act of 1934, ch. 404, 48 Stat. 881, 15 U.S.C. §§ 78a–78mm (2000); 15 U.S.C. § 78m(a) (2000). Under existing rules, enterprises with \$10 million or more

addition, many privately-held companies must supply audited financial statements to lenders or to shareholders. Finally, even governmental entities, not-for-profit organizations, churches, and other organizations frequently undergo audits.

Financial statements present various assertions, including that reported liabilities actually exist; expenses and losses occurred during the particular accounting period; the financial statements record the enterprise's liabilities, expenses, and losses at appropriate amounts; and the financial statements contain any necessary disclosures.⁷⁵ In every audit engagement, therefore, generally accepted auditing standards require the auditor to use reasonable efforts to determine whether any material unrecorded or undisclosed liabilities exist. In particular, the auditor must obtain evidence about contingent liabilities arising from litigation, claims, assessments, and other uncertainties to determine whether the enterprise has properly treated those items in the financial statements.⁷⁶

1. *Audit Procedures*

SAS No. 12 offers guidance to auditors regarding the appropriate procedures for obtaining evidence and evaluating management's assertions related to litigation contingencies.⁷⁷ Those procedures require an auditor to obtain certain information and representations from the client, examine certain documents that might reveal litigation, and seek corroborating audit evidence from the client's lawyer. First, SAS No. 12 requires the auditor to obtain a description and evaluation of litigation, including identification of matters referred to legal counsel, from management. As part of this process, the auditor requests a "management letter," which provides written assurances that the audit client has properly treated all asserted and unasserted claims against it.⁷⁸ Second, the auditor must "examine documents in the client's possession concerning

in assets and 500 or more owners of any class of equity securities must file periodic reports with the SEC, even if their securities are not traded on a national securities exchange. 17 C.F.R. § 240.12g-1 (2002).

⁷⁵ EVIDENTIAL MATTER, Statement on Auditing Standards No. 31, ¶¶ 3-8 (American Inst. of Certified Pub. Accountants 1980).

⁷⁶ INQUIRY OF A CLIENT'S LAWYER CONCERNING LITIG., CLAIMS, AND ASSESSMENTS, Statement on Auditing Standards No. 12, ¶¶ 1-2 (American Inst. of Certified Pub. Accountants 1976). Statements on Auditing Standards reflect the AICPA's interpretations of GAAS. The AICPA has delegated the responsibility for developing and approving such standards to the Auditing Standards Board ("ASB"). The ASB develops and approves standards that AICPA members must follow in audits. HERWITZ & BARRETT, *supra* note *, at 217.

⁷⁷ *Id.*

⁷⁸ *Id.* ¶ 5(b).

litigation.”⁷⁹ Along these same lines, the auditor must review board minutes, contracts, loan agreements, and other related documents that might disclose litigation.⁸⁰ Finally, the auditor must ask the client to send an “audit inquiry letter” to the client’s lawyer, requesting information about asserted and specified unasserted claims against the client.⁸¹ The client typically requests the lawyer to provide information about litigation, claims, and assessments to the auditor.⁸²

2. Audit Workpapers

With the exception of the audit inquiry letter sent to the client’s lawyer, the form and content of the documentation that the auditor obtains and prepares regarding any litigation contingencies will vary from audit to audit. The auditor uses “workpapers,” sometimes called “working papers,” to document audit procedures and conclusions. The term “working papers” refers to “records kept by the auditor of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in the engagement.”⁸³ Accordingly, workpapers may include “audit programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules or commentaries prepared or obtained by the auditor.”⁸⁴

Among other things, the workpapers contain the auditor’s evaluation of the adequacy and reasonableness of the client’s treatment of litigation contingencies in the financial statements and related notes. At a minimum, the working papers will contain management’s listing of any lawsuits that the client has determined meet the requirements for disclosure or accrual under SFAS No. 5 and the lawyer’s response to the audit inquiry letter.⁸⁵ In addition, the working papers often contain supporting documentation gathered by management, the auditor, or both. Because the auditor must assess management’s conclusions regarding the appropriate financial accounting treatment of litigation contingencies under SFAS No. 5, the auditor’s workpapers may contain information concerning management’s determinations of the probability of unfavorable outcomes and its

⁷⁹ *Id.* ¶ 5(c).

⁸⁰ *Id.* ¶ 7(a)–(d). Auditors typically undertake this procedure for various other reasons in an audit.

⁸¹ *Id.* ¶¶ 6, 8.

⁸² INQUIRY OF A CLIENT’S LAWYER CONCERNING LITIG., CLAIMS, AND ASSESSMENTS, *supra* note 76, ¶¶ 6, 8.

⁸³ WORKING PAPERS, Statement on Auditing Standards No. 41, ¶ 3 (American Inst. of Certified Pub. Accountants 1982).

⁸⁴ *Id.*

⁸⁵ *See id.* ¶¶ 4, 5(b).

estimates of any potential losses.⁸⁶ Of course, the lawyer's opinions and conclusions often influence management's assessments and the auditor's evaluation. Thus, the workpapers might also include discussion or notation regarding the weight that the auditor and management accorded to the lawyer's opinions.

3. *Public Oversight Board*

In 1977, the American Institute of Certified Public Accountants ("AICPA") formed the SEC Practice Section ("SECPS") as part of the Institute's Division for CPA Firms and established the Public Oversight Board ("POB"), a five-member, autonomous body, to oversee the SECPS. In that capacity and until May 1, 2002,⁸⁷ the POB monitored the quality control programs that the public accounting firms that audit publicly held enterprises had implemented. Every three years, the POB required SECPS members to submit their practices to peer review by other accountants. In addition, the POB studied litigation against member firms alleging audit failures involving publicly traded enterprises to determine whether those firms needed to take corrective actions to strengthen their quality control systems or to address personnel deficiencies. The POB required SECPS members to report litigation and send copies of complaints within thirty days.

After such a report, the Quality Control Inquiry Committee ("QCIC") investigated the complaint. Where appropriate, the QCIC referred the matter to the AICPA Professional Ethics Division for potential disciplinary action. In cases involving alleged audit failures, the files and staff of the QCIC and the AICPA Professional Ethics Division may provide information related to the underlying litigation.

⁸⁶ See *id.* ¶ 3.

⁸⁷ Following the collapse of Enron Corp., the SEC developed a plan to overhaul oversight of the accounting profession. Michael Schroeder, *SEC Proposes Accounting Disciplinary Body*, WALL ST. J., Jan. 17, 2002, at C1. The plan proposed a new organization to oversee disciplinary reviews of accountants, replacing the POB's disciplinary functions. *Id.* In protest to the SEC's plan, the POB voted to disband on January 20, 2002, and subsequently terminated its existence on May 1, 2002. PUB. OVERSIGHT BD., FINAL ANNUAL REPORT 2001 (2002), <http://www.publicoversightboard.org/2001.pdf>. Noting that a large minority of the proposed board's members would come from the accounting profession, the POB determined that the SEC's plan would actually hurt the effectiveness of independent oversight, giving the accounting profession more control. Scot J. Paltrow & Jonathan Weil, *Accounting Industry Review Board Votes to End Its Existence in Protest*, WALL ST. J., Jan. 23, 2002, at A2. The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, establishes a five-member oversight board, only two members of which can be or have been certified public accountants. *Id.* § 101(e), 116 Stat. at 751. See *supra* note 18.

C. Responses to Audit Inquiries

An enterprise's auditors and lawyers view accruals arising from, and disclosures related to, litigation contingencies quite differently. The enterprise's auditors generally want to encourage as much disclosure as possible, or even adequate accruals, to ensure that the financial statements do not understate or overlook material liabilities. In the absence of an accrual, the auditor wants the financial statements to disclose as much information as possible about a material contingent liability to communicate all relevant information to the users of financial statements. In addition, the auditor wants to gather as much information as possible to support the enterprise's treatment of contingent liabilities. Disclosure and documentation help to protect the auditor from liability if the client experiences future financial problems. Lawyers, on the other hand, strive to protect the attorney-client privilege. These goals conflict, because a lawyer's disclosure of information to auditors can waive the attorney-client privilege. An attorney, however, cannot simply avoid the issues arising from audit inquiry letters by refusing to respond. Failing to reply to an audit inquiry letter can prevent the auditor from issuing an unqualified opinion. As a result, lawyers must exercise great care in responding to these audit inquiry letters.

In December 1975, the American Bar Association (the "ABA") issued a Statement of Policy to set forth the legal profession's official policy on responses to audit inquiry letters.⁸⁸ The ABA designed the Statement of Policy (the "ABA Statement of Policy") to address the dual concerns that a lawyer's disclosure of some confidential information to an outside auditor may waive the attorney-client privilege, at the same time that non-disclosure could prevent the auditor from issuing an unqualified opinion.⁸⁹ The ABA feared that these concerns would discourage clients, especially corporations, from discussing potential legal problems with their lawyers.⁹⁰ The Commentary that accompanied the ABA Statement of Policy explicitly sets forth the ABA's expectation that

⁸⁸ A.B.A., *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information*, 31 BUS. LAW. 1709, 1709 (1976) [hereinafter A.B.A., *Statement of Policy*]. The American Bar Association's Section of Business Law has compiled, and occasionally updates, the "principal official pronouncements and unofficial commentaries [discussing] audit inquiries and lawyers' responses." COMM. ON AUDIT INQUIRY RESPONSES, A.B.A., AUDITOR'S LETTER HANDBOOK 1 (1990). In addition, *The Business Lawyer*, the Section of Business Law's quarterly publication, periodically contains articles which discuss developments in this area. See, e.g., Subcomm. on Audit Inquiry Responses, A.B.A., *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretation AU Section 337*, 45 BUS. LAW. 2245 (1990); James J. Fuld, *Lawyers' Responses to Auditors—Some Practical Aspects*, 44 BUS. LAW. 159 (1988).

⁸⁹ See A.B.A., *Statement of Policy*, *supra* note 88, at 1709–10.

⁹⁰ *Id.*

communications between lawyers and auditors in accordance with the Statement of Policy would not prove prejudicial to clients engaged in, or facing, adversary proceedings.⁹¹ In addition, the Commentary specifically recognized that if developments occur to negate this expectation, the ABA may need to review and revise the Statement of Policy.⁹²

To encourage future attorney-client communications, to provide maximum protection to such communications, and to seek to assure confidentiality to corporate clients, the ABA Statement of Policy addresses several issues regarding the lawyer's response, including client consent, the scope of permissible use, general limits on the scope of response, and specific limits regarding materiality, types of contingencies, and evaluation of claims. In addition, the ABA Statement of Policy establishes certain suggested parameters for the lawyer's response.

1. *Client Consent*

Recognized professional responsibilities and ethical considerations require a lawyer to preserve a client's confidences and secrets.⁹³ At the time of the ABA Statement of Policy, the ABA's Model Code of Professional Responsibility (the "MCPR") defined client confidences as information that the attorney-client privilege protected.⁹⁴ The MCPR defined client secrets as information gained during the professional relationship between the lawyer and the client that the client requested the lawyer to hold in confidence or that would embarrass or otherwise harm the client if revealed.⁹⁵ Because any disclosure related to a particular subject matter may effectively waive any privilege with respect to

⁹¹ *Id.* at 1717.

⁹² *Id.*

⁹³ MODEL CODE OF PROF'L RESPONSIBILITY EC 4-1 (1980). The ABA adopted the Model Code of Professional Responsibility ("MCPR") in 1969. In 1977, two years after approving the ABA Statement of Policy, the ABA formed a committee to evaluate the MCPR and to write the new Model Rules of Professional Conduct ("Model Rules"). Like the MCPR, the Model Rules require a lawyer to maintain client confidentiality. MODEL RULES OF PROF'L CONDUCT R. 1.6 (2001).

⁹⁴ MODEL CODE OF PROF'L RESPONSIBILITY DR 4-101(A) (1980). Courts have long recognized that a corporation can claim the attorney-client privilege. *See, e.g.,* Upjohn Co. v. United States, 449 U.S. 383, 389-90 (1981) (expanding the corporate attorney-client privilege to low- and mid-level employees when the corporation must defend against litigation); *see also* Newport Pac., Inc. v. County of San Diego, 200 F.R.D. 628, 630-31 (S.D. Cal. 2001) (stating that "[t]here is no longer any question that the attorney-client privilege may be asserted by a corporation"); *Radiant Burners, Inc. v. Am. Gas Ass'n*, 320 F.2d 314, 323 (7th Cir. 1963) (holding that the attorney-client privilege is available to a corporation).

⁹⁵ MODEL CODE OF PROF'L RESPONSIBILITY DR 4-101(A) (1980).

related communications, a lawyer should carefully evaluate and discuss with the client the legal consequences of disclosure to an independent auditor.⁹⁶ To address the issue of the lawyer's ethical obligation to preserve client confidentiality, the ABA Statement of Policy lists four criteria that a lawyer should employ to ensure client consent to the disclosures.

First, an agent of the client with the authority to render such a request must sign the initial letter requesting that the lawyer prepare the audit inquiry response.⁹⁷ If the requested information will not disclose a confidence or secret and does not require the lawyer to evaluate the merits of a claim,⁹⁸ the lawyer may then provide the information to the auditor without further consent.⁹⁹

Second, the ABA Statement of Policy notes that the initial request letter that the client sends to the lawyer generally does not supply the consent necessary to disclose a confidence or secret or to evaluate a claim. The client or an authorized agent can only consent to such a disclosure after the lawyer has fully informed the client about the resulting legal consequences.¹⁰⁰ Third, the ABA Statement of Policy cautions that lawyers should remember that an adverse party might assert that any evaluation of potential liability constitutes an admission.¹⁰¹

Finally, to secure the client's full consent, the ABA Statement of Policy advises the lawyer to ask the client to review and approve the lawyer's response to the audit inquiry letter before the lawyer transmits the response to the auditor.¹⁰² The ABA Statement of Policy also notes that the lawyer should provide additional explanation and advice to the client so that the client fully understands the legal consequences of any disclosure.¹⁰³ Such a procedure seeks to enable the client to compare the costs of potentially waiving the attorney-client privilege against the benefits of an unqualified opinion from the auditor.

2. *Limits on Permissible Use*

Unless the lawyer states otherwise, only the auditor can use the lawyer's response and only in connection with the audit.¹⁰⁴ In particular, the client should not quote or refer to the letter in the client's financial statements or any

⁹⁶ See *infra* notes 235–55 and accompanying text.

⁹⁷ A.B.A., *Statement of Policy*, *supra* note 88, at 1711.

⁹⁸ The work product doctrine may, or may not, protect such an evaluation. See *infra* notes 265–320 and accompanying text.

⁹⁹ A.B.A., *Statement of Policy*, *supra* note 88, at 1711.

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.* at 1715.

accompanying notes or file the letter with any governmental agency or other person without the lawyer's prior written consent.¹⁰⁵ Either action would almost certainly waive the attorney-client privilege with respect to related information. If the auditor gives the lawyer advance written notice, the ABA Statement of Policy acknowledges that the auditor may furnish the lawyer's response to comply with a court order or to defend against a malpractice charge arising from the audit.¹⁰⁶

3. *General Limitations on the Scope of the Response*

In addition to the specific limits on materiality, types of contingencies, and evaluation of claims discussed in the following sections, the ABA Statement of Policy also contemplates three general limitations on the scope of the lawyer's response. These general limitations seek to prevent the unnecessary disclosure of information that may waive the attorney-client privilege with respect to any related information. Whenever a lawyer or law firm so limits the response to an audit inquiry letter, the response should communicate such limits.¹⁰⁷

First, the lawyer should set forth in the response, by way of limitation, the scope of the legal engagement.¹⁰⁸ In addition, unless the lawyer's response indicates otherwise, the lawyer should limit the response to matters for which the lawyer devoted substantive attention through either legal representation or consultation since the beginning of the period or periods undergoing audit.¹⁰⁹

Second, the ABA Statement of Policy advises the lawyer both to indicate the date as of which the response furnishes information and to disclaim any obligation to advise the auditor about any changes in that information that might come to the lawyer's attention after such date.¹¹⁰

¹⁰⁵ A.B.A., *Statement of Policy*, *supra* note 88, at 1715.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.* at 1712. The ABA Statement of Policy contemplates that the attorney can use the following statement in the response to incorporate by reference these limitations:

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any 'loss contingencies' is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement).

Id. at 1715.

¹⁰⁸ *Id.* at 1711

¹⁰⁹ *Id.* at 1711.

¹¹⁰ *Id.*

Third, the ABA Statement of Policy states that when a law firm or law department responds to the audit inquiry, the auditor may assume that the firm or department has attempted to determine, from lawyers currently in the firm or department, and who performed legal services during the relevant financial accounting period or periods, whether those services constituted substantive legal attention.¹¹¹ The auditor may not assume, however, that the law firm or department has reviewed any of the client's transactions or other matters to identify any loss contingencies that the client has not identified.¹¹² In other words, the lawyer does not need to search the company's files for unknown loss contingencies when preparing the audit inquiry response. If the lawyer recognizes unasserted possible claims or assessments in the course of providing regular legal services, the ABA Statement of Policy does not automatically require the lawyer to disclose those unasserted claims or assessments to the auditor. Rather, a lawyer's professional obligations require the lawyer to call those matters to the client's attention and to advise the client about any disclosures that the lawyer considers required or desirable.¹¹³

4. *Materiality*

In addition to the general limitations on the response, the lawyer may further limit the disclosures in the response to contingencies that satisfy a specified materiality threshold. In other words, the lawyer may optionally indicate that the response limits the disclosure of loss contingencies to items that the lawyer considers, either individually or collectively, material to the client's financial statements.¹¹⁴ In assessing what constitutes a material contingency, the lawyer could first quantify each item and then select, and apply, a test.¹¹⁵ Tests to determine materiality could include: (1) matters involving an amount in excess of a certain dollar amount; (2) matters containing a maximum potential loss exceeding a certain amount; (3) matters the expected effects of which would exceed a certain amount; or (4) claims exceeding a certain amount.¹¹⁶ The fourth

¹¹¹ A.B.A., *Statement of Policy*, *supra* note 88, at 1711.

¹¹² *Id.*; see also A.B.A., *Introductory Analysis and Guides to Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information—Prepared by the Committee on Audit Inquiry Responses*, 31 BUS. LAW. 1737, 1739 (1976) (stating that the lawyer's obligation to consult with the client regarding unasserted claims does not require the lawyer to go out of the way to search for or develop facts regarding possible claims other than those that are apparent through the lawyer's legal work for the client).

¹¹³ A.B.A., *supra* note 112, at 1739.

¹¹⁴ A.B.A., *Statement of Policy*, *supra* note 88, at 1712.

¹¹⁵ Fuld, *supra* note 88, at 159.

¹¹⁶ *Id.* at 159–60.

test, while easily determinable, presents practical problems because some claims involve enormous claims for punitive damages.¹¹⁷

To avoid quantifying each loss contingency, a lawyer could alternatively develop a test for materiality that does not require a specific quantification. For example, a response could address only those "matters which may materially affect the financial condition of the company."¹¹⁸ For this particular test, however, the lawyer must determine what "materially affect" means. That standard may include a percentage of net worth, a percentage of total liabilities, or some other similar test. No matter what standard the lawyer chooses to use to determine materiality, the lawyer should indicate that standard in the response. In addition, the lawyer should explicitly state that the response only addresses contingencies that meet or exceed that standard.¹¹⁹

5. *Types of Contingencies*

In the response to the audit inquiry letter, the lawyer should limit the response to three types of loss contingencies: overtly threatened or pending litigation; contractually assumed obligations; and unasserted possible claims or assessments.¹²⁰

The lawyer should address overtly threatened or pending litigation, even if the client has not specified such matters in the request for information, whenever a potential claimant has indicated an awareness of and intention to assert a possible claim or assessment.¹²¹ In the case of overtly threatened or pending litigation, the lawyer should further limit the response to possible claims or assessments for which the lawyer considers the likelihood of avoiding litigation or settlement as "remote."¹²²

By comparison, the lawyer should address unasserted possible claims or assessments in the response to an audit inquiry letter only when the client has identified and asked the lawyer to comment on each specific unasserted possible claim or assessment.¹²³ The lawyer should advise the client to request disclosure about unasserted possible claims or assessments only if the following three conditions apply: the client has determined that the claimant will probably assert a claim; the client considers the likelihood of an unfavorable outcome as at least reasonably possible; and any resulting loss would materially affect the client's

¹¹⁷ *Id.* at 160.

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ A.B.A., *Statement of Policy*, *supra* note 88, at 1712.

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Id.*

financial condition.¹²⁴ Unasserted possible claims or assessments include catastrophes, accidents, or other similar occurrences in which the circumstances openly and notoriously suggest the client's potential liability; government investigations in which the authorities have instituted, or almost certainly will institute, enforcement proceedings, and where the client would normally expect private claims to remedy the situation; and other circumstances in which the client's public disclosures acknowledge the existence of one or more probable claims arising from a specific event or occurrence.¹²⁵ In this regard, however, the lawyer should not confirm to the auditor the completeness of the client's list of unasserted claims or assessments.¹²⁶

6. *Specific Recommendations Regarding Disclosures*

According to the ABA Statement of Policy, the lawyer should limit the information provided to the auditor to an identification of the matter, the stage of the proceedings, the claims that litigation opponents or other third parties have asserted, and the client's stated position regarding the claims.¹²⁷ More importantly, the ABA Statement of Policy recommends that the lawyer not express an opinion as to the possibility of an unfavorable outcome or as to the amount of expected damages.¹²⁸

a. *Possibility of Unfavorable Outcome*

The ABA Statement of Policy recommends that the lawyer almost never express a judgment to the auditor regarding the possibility of an unfavorable outcome.¹²⁹ The ABA Statement further emphasizes that the absence of such a judgment does not necessarily indicate that the lawyer expects an unfavorable outcome.¹³⁰ When a lawyer deems an unfavorable outcome as either "probable" or "remote," however, the lawyer may express that judgment to the outside

¹²⁴ *Id.*

¹²⁵ *Id.* at 1712–13.

¹²⁶ A.B.A., *supra* note 112, at 1739. Because the ABA Statement of Policy requires the lawyer to discuss unasserted claims or assessments only if the client specifically notes and requests the lawyer to discuss such a claim or assessment, the lawyer's assurance of the completeness of the client's disclosure could invite claims against the lawyer if either the client fails to identify an unasserted claim or assessment in the initial request or chooses not to authorize the lawyer to disclose such a claim or assessment.

¹²⁷ A.B.A., *Statement of Policy*, *supra* note 88, at 1712.

¹²⁸ *Id.* at 1713–14.

¹²⁹ *Id.* at 1713.

¹³⁰ *Id.* at 1714.

to accrue, disclose, or both accrue and disclose the claim.¹³⁸ Although the definition in paragraph three of SFAS No. 5 does not expressly apply to this determination, the term “probable” at least arguably still means “likely to occur.” In contrast, the ABA Statement of Policy considers an unasserted claim “probable only when the prospects of its being asserted seem reasonably certain . . . and the prospects of non-assertion seem slight.”¹³⁹

These different definitions and standards can obviously cause problems. For example, the ABA definition of “probable” could lead lawyers to consider fewer unasserted claims than auditors, thereby revealing fewer claims. This creates difficulties for auditors in determining whether to accrue or disclose a claim. The ABA also has a narrower definition of remote than the FASB, so lawyers may consider fewer losses remote than auditors. These conflicting standards can leave clients caught in the middle. Public companies generally need an unqualified opinion from their auditors for their creditors and shareholders. The client also ultimately bears responsibility for any improper disclosures.¹⁴⁰

When the lawyer determines that the client should disclose an unasserted contingency based on the criteria in both SFAS No. 5 and the ABA Statement of Policy, the lawyer must advise the client regarding disclosure to the auditor. The client, however, retains final responsibility for deciding whether or not to disclose a particular contingency. In this regard, the lawyer has an obligation not to participate knowingly in any violations of securities law disclosure requirements.¹⁴¹ Under the MCPR, when the lawyer believes that the loss contingency qualifies as of such material importance and seriousness, and that there is reason to believe that non-disclosure of the matter would violate securities law, the lawyer should advise the client to disclose the matter to the auditor.¹⁴² When the client disregards the lawyer’s advice and commits securities law violations, rules governing professional responsibility may require the lawyer to resign from the client’s employment.¹⁴³

¹³⁸ ACCOUNTING FOR CONTINGENCIES, *supra* note 25, ¶¶ 8, 10.

¹³⁹ A.B.A., *Statement of Policy*, *supra* note 88, at 1713 (emphasis added).

¹⁴⁰ In this regard, the client may face lawsuits from disgruntled shareholders or the SEC if the company does not properly disclose contingencies. *See, e.g., In re Westinghouse Sec. Litig.*, 90 F.3d 696, 707–13 (3d Cir. 1996) (reinstating class action securities fraud claims alleging that a \$975 million pre-tax accrual for loan losses did not adequately cover estimated losses); *see also supra* note 22.

¹⁴¹ A.B.A., *Statement of Policy*, *supra* note 88, at 1714.

¹⁴² *Id.* at 1725.

¹⁴³ *Id.*

b. *Estimate of Potential Loss*

As a general rule, the ABA Statement of Policy provides that a lawyer should not disclose an estimate of potential loss when responding to an audit inquiry letter.¹⁴⁴ When the client or auditor asks the lawyer to estimate the potential loss or range of loss for the response, the lawyer should provide that information only if the probability of an inaccurate estimate is slight.¹⁴⁵ The ABA Statement of Policy notes that, in most cases, the lawyer will be unable to sufficiently assess the potential loss or range of loss, and the probability of an inaccurate estimate will be more than slight.¹⁴⁶

III. THREE SIGNIFICANT DEVELOPMENTS AFTER THE 1975 ACCORD AND RELATED INFORMATION AND DOCUMENTATION

Ever since the 1975 accord between the accounting and legal professions, both the business community and the legal academy have generally assumed that the accord simultaneously protects the confidentiality of lawyer-client communications and allows the auditing profession to follow standards and procedures that preserve confidence in the auditing process and audited financial statements. After the professions reached the 1975 accord, however, a 1980 SEC administrative release, a 1984 Supreme Court decision, and a provision in the Tax Reform Act of 1984 have fundamentally changed the legal landscape behind the accord, with barely any notice from most academics and lawyers.

First, beginning in 1980, the enhanced disclosure rules for Management's Discussion and Analysis require SEC registrants to disclose certain forward-looking information, including any "currently known trends, events and uncertainties" that a registrant reasonably expects will have a material impact on its liquidity, financial condition or results of operations.¹⁴⁷ Because the federal securities laws use a lower materiality threshold than GAAP, the MD&A requirements mandate disclosure in situations that may not qualify as material for financial accounting purposes.¹⁴⁸ Second, in *United States v. Arthur Young & Co.*,¹⁴⁹ the Supreme Court held that the IRS could summons tax accrual workpapers that the auditing firm Arthur Young prepared to evaluate Amerada Hess Corp.'s reserves for contingent tax liabilities. In dicta, the Supreme Court opined that Rule 26(b)(1) of the Federal Rules of Civil Procedure would give the

¹⁴⁴ *Id.* at 1714.

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*

¹⁴⁷ 17 C.F.R. § 229.303 (2002).

¹⁴⁸ See *infra* notes 169–72 and accompanying text.

¹⁴⁹ 465 U.S. 805 (1984).

SEC or a private plaintiff in securities litigation access to these workpapers.¹⁵⁰ Third, in the Tax Reform Act of 1984, Congress added the "economic performance" requirement to § 461(h) of the Internal Revenue Code.¹⁵¹ As a result, enterprises frequently cannot deduct, for tax purposes, accrued expenses that affect their financial statements until they actually pay the related liability.¹⁵²

Collectively, these developments provide additional discovery opportunities. First, a litigator should carefully review an opponent's MD&As in any public filings after the incident that gave rise to the underlying litigation. In appropriate cases, the litigator should also seek to discover the audit workpapers and other relevant information from the opponent's auditor. Finally, an opponent's federal income tax returns, especially Schedule M-1, may provide helpful information about any litigation reserves.

A. Management's Discussion and Analysis

The federal securities laws require any enterprise proposing to offer securities to the public, sometimes referred to as "issuers," to disclose certain information and to file financial statements with the SEC.¹⁵³ In addition, so-called "registrants," which include most of the country's largest corporations, such as Merrill Lynch and Disney, specifically those companies whose shares are listed on a national securities exchange, such as the New York Stock Exchange or The Nasdaq Stock Market, Inc., or which meet certain tests relating to total assets and number of shareholders, must file periodic reports and financial statements with the SEC to provide information to the investing public.¹⁵⁴ Collectively, these initial and continuing disclosure obligations seek to prevent misleading or incomplete financial reporting and to enable investors to reach informed decisions.¹⁵⁵

¹⁵⁰ See *infra* notes 180–84 and accompanying text.

¹⁵¹ Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 91(a), (g), 98 Stat. 494, 598–600, 608 (codified at 26 U.S.C. § 461(h) (2000)).

¹⁵² See *infra* notes 185–205 and accompanying text.

¹⁵³ Securities Act of 1933, ch. 38, § 2(4), 48 Stat. 74, 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2000), 15 U.S.C. § 77s(a) (2000)).

¹⁵⁴ See *supra* note 73.

¹⁵⁵ See generally Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1024 (2000) (describing Congress's desire to "substitute a philosophy of full disclosure for the philosophy of caveat emptor" and listing various legal requirements and authorities) (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963)); Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1, 9–16 (reviewing the mandatory disclosure system before offering a critique of its premises).

Under the integrated disclosure requirements, which the SEC adopted in 1980,¹⁵⁶ Regulation S-K provides standard instructions for most enterprises filing forms under the federal securities laws.¹⁵⁷ Items 103 and 303 of Regulation S-K require both issuers and registrants to disclose information related to litigation contingencies.¹⁵⁸ By carefully reviewing these disclosures, a reader may learn information regarding such contingencies that does not appear in the notes to the accompanying financial statements.

Item 103 requires such enterprises to describe briefly any pending and material legal proceedings, other than ordinary routine litigation incidental to the business, when the underlying pleadings name the enterprise or any subsidiary as a party or list any property of either the enterprise or any subsidiary as the subject.¹⁵⁹ The description must include the court or agency before which the proceedings are pending, the date instituted, the principal parties, the factual basis alleged to underlie the proceedings, and the relief sought.¹⁶⁰ Subject to an important exception for environmental proceedings, however, an enterprise need not disclose any information regarding any proceeding that involves primarily a claim for damages if the amount at issue, excluding interest and costs, does not exceed ten percent of the enterprise's consolidated current assets. In computing such percentages, the enterprise must include the amount involved in any other pending or known contemplated proceeding that presents in large degree the same legal and factual issues.¹⁶¹ A special rule, however, applies to environmental litigation. Enterprises must disclose information about environmental litigation if the amount at issue exceeds \$100,000.¹⁶²

¹⁵⁶ The rules apply to both filings under the Securities Act of 1933 and the Securities Exchange Act of 1934. *See supra* notes 153–54 and accompanying text.

¹⁵⁷ 17 C.F.R. §§ 229.10–915 (2002). Regulation S-K applies to both enterprises desiring to offer securities to the public and to registrants which must file periodic reports with the SEC. Regulation S-B contains similar requirements for small business issuers, which have revenues and public floats that fall below \$25 million. 17 C.F.R. §§ 228.10–702 (2002).

¹⁵⁸ In addition, the notes to the financial statements may contain additional disclosures about contingencies related to litigation. *See supra* notes 54–58, 73 and accompanying text.

¹⁵⁹ 17 C.F.R. § 229.103 (2002). Item 103 requires enterprises to disclose information about threatened proceedings only when the enterprise knows that governmental authorities are contemplating such proceedings. *Id.*

¹⁶⁰ *Id.* at instruction 2 (requiring no disclosure where claim for damages does not exceed ten percent of current assets).

¹⁶¹ *Id.*

¹⁶² Although the SEC has required disclosures similar to those found in MD&A since 1968, the framework for the current rules dates back to 1980. *See* Concept Release on Management's Discussion and Analysis of Financial Condition and Operations, Securities Act Release No. 6711, 52 Fed. Reg. 13,715, 13,716 (Apr. 24, 1987); *see also* Amendments to Annual Report Form, Related Forms, Rules, Regulations, and Guides; Integration of Securities

Item 303 requires an issuer or registrant to discuss its liquidity, capital resources, operating results, and other information necessary to understand the financial statements. As such, MD&A mandates disclosure of both historical and certain forward-looking information, including any “currently known trends, events, and uncertainties” that the registrant reasonably expects will have a material impact on its liquidity, financial condition, or operating results.¹⁶³ Such historical and prospective disclosures enable investors and other users to assess not only the registrant’s financial condition and operating results, but also its prospects for the future. Because a numerical presentation and brief accompanying footnotes rarely allow an investor “to judge the *quality of earnings* and the likelihood that past performance is indicative of future performance,”¹⁶⁴ MD&A provides the reader an opportunity to look at the registrant “through the eyes of management” by supplying both a short and long-term perspective. In Financial Reporting Release No. 36 (“FRR No. 36”),¹⁶⁵ the SEC established a “reasonably likely to have a material effect” standard for disclosing forward-looking information and specifically applied that standard to an environmental contingency.¹⁶⁶

Item 303(a) requires additional disclosures when the financial statements do not indicate future operating results or financial condition. The third instruction directs that the discussion should focus specifically on any material events and uncertainties that would cause future operating results to deviate from reported financial information,¹⁶⁷ which the SEC has referred to as affecting the quality of earnings. In a recent consent order resolving public administrative proceedings against a registrant, its former chairman, and several affiliates, the SEC has stated that “Item 303(a) requires that management address any issues which impact the *quality of earnings*.”¹⁶⁸ Without such an explanation, an investor could not judge

Act Disclosure Systems, Securities Act Release No. 6231, 45 Fed. Reg. 63,630 (Sept. 25, 1980).

¹⁶³ 17 C.F.R. § 229.303 (2002).

¹⁶⁴ Management’s Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Securities Act Release No. 6835, 54 Fed. Reg. 22,427, 22,428 (May 24, 1989) (emphasis added).

¹⁶⁵ *Id.*

¹⁶⁶ *Id.*

¹⁶⁷ 17 C.F.R. § 229.303 (2002).

¹⁶⁸ *In re Terex Corp.*, Accounting and Auditing Enforcement Release No. 1126, [1999–2001 Accounting and Auditing Enforcement Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,633, at 63,106 (Apr. 20, 1999) (emphasis added).

the *quality of earnings* and the likelihood that reported financial information would not indicate future operating results.¹⁶⁹

MD&A requires additional information in at least two ways. First, the narrative explanation often provides details not found in the numerical presentation or footnotes accompanying the financial statements. Second, the enhanced disclosure requirements seemingly establish a lower materiality threshold than found in financial statements under GAAP.¹⁷⁰ As a general rule, accountants and auditors generally treat any amount which does not exceed five percent of income before taxes as immaterial. On the other side, auditors usually consider any item which exceeds ten percent of income before taxes as material.¹⁷¹ Although neither the SEC nor the courts have explicitly established a materiality standard for MD&A, they have rejected mathematical standards, preferring a facts and circumstances analysis.¹⁷² Under the federal securities

¹⁶⁹ *Id.*; see also *In re Bank of Boston Corp.*, 60 U.S. Sec. and Exchange Comm'n, SEC Docket 2695, 1995 SEC LEXIS 3456 (Dec. 22, 1995) (involving the failure to disclose known trends and uncertainties in the bank's real estate portfolio that would reasonably be expected to have a material unfavorable impact on the bank's financial condition).

¹⁷⁰ See Bean & Thomas, *supra* note 31, at 120. To the extent that the "reasonably likely to have a material effect" standard in the MD&A requirements mandates disclosure in situations that do not qualify as "material" for accounting purposes, compliance with GAAP may not satisfy disclosure obligations under the federal securities laws.

¹⁷¹ *Id.*; see also Charles Jordan et al., *Materiality for Extraordinary Items*, 35 NAT'L PUB. ACCT., Dec. 1990, at 42, 43 (listing other mathematical guidelines for average net income, total revenues, total assets, and owners' equity).

¹⁷² Compare *Ganino v. Citizens Utils. Co.*, 228 F.3d 154 (2d Cir. 2000) (vacating in part, reversing in part, and remanding for further consideration a district court decision that granted defendants' motion to dismiss after the district court held that the alleged misrepresentations of certain fees qualified as immaterial as a matter of law when the fees amounted to only 1.7 percent of the defendant company's total revenues), with *In re Newell Rubbermaid, Inc. Sec. Litig.*, No. 99 C 6853, 2000 WL 1705279, at *8 (N.D. Ill. Nov. 14, 2000) (granting defendants' motion to dismiss when the alleged \$40 million dollars in undisclosed expenses constituted less than ten percent of the company's before-tax income during the relevant period).

One recent example may illustrate how a quantitatively immaterial item might nevertheless qualify as material. An October 1998 *Wall Street Journal* article describes BankAmerica Corp.'s failure to disclose information about its \$372 million write-down of a loan to D.E. Shaw & Co., a New York investment firm. Even though bank officials knew about possible losses on the loan as early as August, the bank did not disclose the extent of the losses before shareholders voted in late September to approve a \$43 billion dollar merger with NationsBank, which created the nation's second-largest bank. The article quotes the merged bank's chief financial officer as saying that "[\$372 million is] a big number but it's not material to a company' that is as big as BankAmerica." Rick Brooks & Mitchell Pacelle, *BankAmerica Knew in August of Trading Woes*, WALL ST. J., Oct. 16, 1998, at A3. When the merged bank announced the write-down in mid-October, the stock price dropped eleven percent in a single day. Plaintiffs quickly filed multiple class action securities fraud actions

laws, the Supreme Court has concluded that an omitted fact qualifies as material if a substantial likelihood exists that a reasonable investor would have considered the omitted fact important because disclosure would have significantly altered the “total mix” of available information.¹⁷³

As a result, the financial accounting rules and the MD&A requirements may establish different standards. If the MD&A rules in fact impose a lower standard

related to the merger against new BankAmerica and other defendants. *See In re BankAmerica Corp. Sec. Litig.*, 78 F. Supp. 2d 976 (E.D. Mo. 1999) (discussing facts and granting in part and denying in part defendants’ motion to dismiss); *see also* Brooks & Pacelle, *supra*.

In Staff Accounting Bulletin No. 99, the SEC’s staff explicitly rejected the automatic classification of financial statement misstatements or omissions that fall under a five percent threshold as immaterial, absent particularly egregious circumstances, such as misappropriation by senior management. The staff emphasized that registrants and their auditors must consider qualitative factors in materiality determinations. For example, a quantitatively small misstatement or omission could nevertheless qualify as material when it:

- arises from an item capable of precise measurement;
- masks a change in earnings or other trends;
- hides a failure to meet analysts’ consensus expectations for the enterprise;
- changes a loss into income or vice versa;
- concerns a segment or other portion of the registrant’s business that has been identified as playing a significant role in the registrant’s operations or profitability;
- determines the registrant’s compliance with regulatory requirements;
- affects the registrant’s compliance with loan covenants or other contractual requirements;
- increases management’s compensation—for example, by satisfying a requirement for the award of bonuses or other forms of incentive compensation; or
- involves concealment of an unlawful transaction.

In assessing multiple misstatements, the bulletin reminds registrants and auditors that they must consider all misstatements or omissions both separately and in the aggregate to determine whether, in relation to the individual line item amounts, subtotals, or totals in the financial statements, the misstatements or omissions materially misstate the financial statements taken as a whole. Finally, the SAB reminds registrants that immaterial, but intentional misstatements can violate the federal securities laws. Materiality, Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150, 45,153–54 (Aug. 19, 1999), *reprinted in* 7 Fed. Sec. L. Rep. (CCH) ¶ 75,501, at 64,219-3 (Sept. 6, 2000); *see also* Kenneth C. Fang & Brad Jacobs, *Clarifying and Protecting Materiality Standards in Financial Statements: A Review of SEC Staff Accounting Bulletin 99*, 55 BUS. LAW. 1039 (2000) (tracing the development of materiality standards, examining the purpose and reasoning behind SAB No. 99’s release, and concluding that the bulletin creates an ambiguous standard that opens the door to liability for innocent mistakes in judgment).

¹⁷³ *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (interpreting Rule 10b-5); *TSC Indus., Inc. v. Northway*, 426 U.S. 438, 448–49 (1976) (proxy rules); *see also* 17 C.F.R. §§ 230.405, 240.12b-2 (2002) (“The term ‘material,’ when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities registered.”).

for disclosure, an issuer or registrant could theoretically observe GAAP but still violate the federal securities laws.¹⁷⁴ In the process, a lawyer advising the registrant about disclosure obligations under the securities laws could conceivably commit professional malpractice. For this reason, issues about whether or how to disclose information about contingencies frequently perplex securities lawyers, particularly given the SEC's recent emphasis on the MD&A requirements.

Second, does the "reasonably likely" standard for MD&A purposes differ from the "reasonably possible" likelihood which would otherwise require disclosure under SFAS No. 5? In *Greenstone v. Cambex Corp.*,¹⁷⁵ the First Circuit—in an opinion that then Chief Judge, now Justice, Breyer authored—explicitly recognized, but did not decide, the issue. In the opinion's last paragraph, the court observed:

We need not . . . decide whether the appropriate standard is knowledge (1) that an IBM Credit lawsuit was "probable" or (2) that the lawsuit (or some similar loss) was "reasonably likely[.]" Whether the standard is one or the other or yet some third similar standard (such as "reasonably expects"), we should reach the same result.¹⁷⁶

In the years ahead, we can expect lawyers and the courts to face this potentially important issue.

Failing to comply with Item 303 could cause the SEC to initiate cease and desist proceedings. To date, however, no reported decision has imposed liability under a private cause of action for an Item 303 violation.¹⁷⁷ In any event, if an

¹⁷⁴ See, e.g., *In re Caterpillar, Inc.*, Accounting and Auditing Enforcement Release No. 363, [1991–1995 Accounting and Auditing Enforcement Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶73,830, at 63,055 (Mar. 31, 1992).

¹⁷⁵ 975 F.2d 22 (1st Cir. 1992). In that case, the First Circuit affirmed the district court's decision dismissing a securities fraud claim because the investor did not plead "with particularity" any specific factual allegations supporting the conclusion that Cambex or its officers knew that the company faced a significant possibility of loss arising from certain IBM Credit leases prior to the time that IBM Credit filed the lawsuit.

¹⁷⁶ *Id.* at 28.

¹⁷⁷ See, e.g., *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1419 n.7 (3d Cir. 1997) ("It is an open issue whether violations of Item 303 create an independent cause of action for private plaintiffs."); *In re Canandaigua Sec. Litig.*, 944 F. Supp. 1202, 1209 n.4 (S.D.N.Y. 1996) ("It is far from certain that the requirement that there be a duty to disclose under Rule 10b-5 may be satisfied by importing the disclosure duties from S-K 303."); *Alfus v. Pyramid Tech. Corp.*, 764 F. Supp. 598, 608 (N.D. Cal. 1991) (concluding that plaintiff must show a separate duty to disclose, apart from Item 303, before a violation of Rule 10b-5 exists); see also Brian Neach, Note, *Item 303's Role in Private Causes of Action Under the Federal Securities Laws*, 76 NOTRE DAME L. REV. 741 (2001) (discussing various private causes of

opponent in litigation must file reports with the SEC,¹⁷⁸ a litigator should monitor the opponent's periodic filings in an effort to get a quick read of management's outlook on the lawsuit.¹⁷⁹

B. *United States v. Arthur Young & Co.*

Until 1984, many accountants and lawyers presumed that third parties, such as the IRS and private plaintiffs in litigation, could not discover audit workpapers. In *United States v. Arthur Young & Co.*,¹⁸⁰ however, the Supreme Court reversed that portion of a court of appeals' decision that refused to enforce an IRS summons as to all Amerada Hess Corp.'s tax accrual workpapers in the files of its auditor Arthur Young. In so holding, the Supreme Court specifically rejected the argument that fundamental fairness precludes IRS access to accountants' tax accrual workpapers as follows:

[I]f the SEC itself, or a private plaintiff in securities litigation, sought to obtain the tax accrual workpapers at issue in this case, they would surely be entitled to do so. . . . [N]o sound reason exists for conferring lesser authority upon the IRS than upon a private litigant suing with regard to transactions concerning which the public has no interest.¹⁸¹

In the related footnote sixteen, the Supreme Court opined that Rule 26(b)(1) of the Federal Rules of Civil Procedure would give the SEC or a private plaintiff in

action that can implicate Item 303); Suzanne J. Romajas, Note, *The Duty to Disclose Forward-Looking Information: A Look at the Future of MD&A*, 61 *FORDHAM L. REV.* S245, S256 (1993) (Survey Issue).

¹⁷⁸ See *supra* notes 154–70 and accompanying text.

¹⁷⁹ Companies must file reports with the SEC, and in some instances send those reports to shareholders, in a number of situations. The SEC requires companies to file annual reports on Form 10-K, quarterly reports on Form 10-Q, and Form 8-K to disclose relevant financial matters. See 17 C.F.R. §§ 240.13a-1, .13a-11, .13a-13 (2002). In the context of public offerings, 15 U.S.C. § 77g, Schedule A, Items 25–26 (2000), require registration statements to include an audited balance sheet and income statement along with footnote disclosures. Finally, Rule 14a-3 requires companies to send shareholders an annual report prior to any proxy solicitation that relates to an annual shareholders' meeting. 17 C.F.R. § 240.14a-3 (2002). All of these filings are available through the SEC's EDGAR database, www.sec.gov/edaux/searches.htm.

¹⁸⁰ 465 U.S. 805 (1984). Some scholarship discusses other aspects of the *Arthur Young* decision. See generally A.A. Sommer, *Working with Auditors*, in *SIXTEENTH ANNUAL INSTITUTE ON SECURITIES REGULATION* 263 (Stephen J. Friedman et al. eds., 1985); Frank J. Magill, Jr., Note, *The Accountant-Client Work Product Privilege: United States v. Arthur Young & Co.*, 38 *TAX LAW* 457 (1985).

¹⁸¹ *Arthur Young*, 465 U.S. at 820 (footnote omitted).

securities litigation access to these workpapers.¹⁸² In so ruling, the Supreme Court specifically rejected the “work-product immunity doctrine for tax accrual workpapers prepared by independent auditors in the course of compliance with the federal securities laws” that the court of appeals had fashioned. The *Arthur Young* decision, and especially the dicta in footnote sixteen, support expansive discovery of information about litigation reserves and similar accounting-related information. Perhaps even more significantly, the Supreme Court also specifically repudiated the court of appeals’ holding “that the public interest in promoting full disclosure to public accountants, and in turn ensuring the integrity of the securities markets, required protection for the work that such independent auditors perform for publicly owned companies,”¹⁸³ concluding, at least under the circumstances in that case, that “[t]his kind of policy choice is best left to the Legislative Branch.”¹⁸⁴

After the dicta in *Arthur Young*, and in the context of the litigation between Orange and Merrill Lynch, a litigator might ask the following questions: Could Orange County use information from Merrill Lynch’s securities filings to extract information from Deloitte & Touche, LLP, the company’s auditor, about Merrill Lynch’s accruals during discovery? Even if management and the auditor agree that SFAS No. 5 does not require the registrant to accrue a contingent liability, could a litigation opponent discover underlying facts which led to, but which may not entirely support, the auditor’s conclusion? Could Orange County discover the responses of Merrill Lynch’s outside counsel to Deloitte & Touche’s audit inquiry letters during the litigation? Could Orange County use any information produced to uncover other relevant facts or to gather insights about Merrill Lynch’s litigating strategy? Could Merrill Lynch protect any information about or supporting its contingencies under the attorney-client or

¹⁸² *Id.* at n.16 (“See, e.g., . . . Fed. Rule Civ. Proc. 26(b)(1) (parties may obtain discovery of ‘any matter, not privileged, which is relevant to the subject matter involved in the pending action.’)”). Remarkably, no reported decision after *Arthur Young* has cited footnote sixteen. Only one case, *In re GHR Cos.*, 41 B.R. 655 (Bankr. Mass. 1984), has quoted the language referred to in the text above that precedes footnote sixteen. In that case, GHR’s creditors sought to discover certain documents from GHR and its accountants for the years preceding GHR’s bankruptcy. Those documents included so-called Matters for Attention of Partners that detailed information that the audit staff believed warranted a partner’s decision, audit strategy documentation, audit workpapers, internal control questionnaires, and tax workpapers. The creditors believed that given the magnitude of IRS claims involved in GHR’s bankruptcy, they needed to determine GHR’s tax liability to develop a disclosure statement and plan of reorganization and to determine whether they should appoint a trustee. GHR and its auditors argued that the work product doctrine protected those documents. In rejecting that argument, the court cited *Arthur Young*, quoting the language that precedes footnote sixteen. *Id.* at 661–63.

¹⁸³ *Arthur Young*, 465 U.S. at 810.

¹⁸⁴ *Id.* at 821.

accountant-client privileges? Does the work product doctrine exempt such information from discovery?

C. "Economic Performance" Requirement

As a result of the Tax Reform Act of 1984, sometimes more broadly referred to as the Deficit Reduction Act of 1984,¹⁸⁵ the Internal Revenue Code (the "Code")¹⁸⁶ now precludes an enterprise from claiming a deduction on its federal income tax return for accrued expenses related to certain contingencies that otherwise reduce net income or loss for financial accounting purposes until the enterprise actually pays the corresponding liability.¹⁸⁷ Under SFAS No. 5, recall that an enterprise must accrue an expense or loss when: (1) the surrounding facts and circumstances render it "probable" that an asset has been impaired or that the enterprise has incurred a liability *and* (2) the enterprise can reasonably estimate the amount of the loss or expense.¹⁸⁸ In contrast, case law and Treasury regulations have long prohibited an accrual method taxpayer¹⁸⁹ from deducting

¹⁸⁵ Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 1(a), 5(a), 98 Stat. 494, 494.

¹⁸⁶ Unless otherwise stated, all references to the Internal Revenue Code, sometimes referred to as the "Code," are to the Internal Revenue Code of 1986, found at 26 U.S.C., as amended.

¹⁸⁷ Even before the Tax Reform Act of 1984, enterprises could not deduct, on their tax returns, some items that they quite properly treated as accrued expenses for financial accounting purposes. *See, e.g.,* United States v. Gen. Dynamics Corp., 481 U.S. 239, 239-47 (1987) (holding that taxpayer providing medical benefits to its employees could not deduct an estimate of its obligation to pay for medical care that its employees or their qualified dependents had obtained during the final quarter of the 1972 tax year, when the employees had not reported the claims to the taxpayer before the end of the year).

¹⁸⁸ *See supra* note 49 and accompanying text.

¹⁸⁹ As a general proposition, an accrual method taxpayer reports income when earned and deducts expenses when incurred. In contrast, a cash method taxpayer generally reports income when actually or constructively received and deducts expenses when paid.

As described below, the Code requires certain enterprises to use the accrual method. In simple terms, multiple owners can conduct a business as either a partnership, corporation, or limited liability company. Partnerships, including limited partnerships, limited liability partnerships, and limited liability limited partnerships, do not pay federal income taxes on their incomes, but pass through any profits or losses to their partners, who must include their allocable share of the partnership's profit or loss on their tax returns. In contrast, unless a corporation qualifies as a "small business corporation" under the Code and files a special election opting into treatment as a subchapter S corporation, the Code treats it as a separate taxpaying entity, which must file tax returns and pay taxes. Because subchapter C of the Code sets forth rules for these separate taxpaying entities, this footnote will refer to these corporations as "subchapter C corporations." Similar to partnerships, subchapter S corporations generally pass through any profits and losses to their shareholders, who must include their pro rata share of the S corporation's profit or loss on their tax returns. Under the classification

an expense for federal income tax purposes until the item satisfies the "all events" test.¹⁹⁰ Under those regulations, an accrual method taxpayer could only deduct an accrued expense if: (1) all events had occurred that determined the fact of the taxpayer's liability for the expense and (2) the taxpayer could determine the liability with reasonable accuracy.¹⁹¹

In the Tax Reform Act of 1984, Congress not only explicitly incorporated the "all events" test into the Code,¹⁹² but also added an "economic performance" requirement to that test, both effective July 18, 1984.¹⁹³ As a result, Code § 461 now provides that an accrual method taxpayer meets the "all events" test when "all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy."¹⁹⁴ In addition, the Code states that "in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated

regulations, a limited liability company with more than one owner, or member, can generally qualify for either partnership or corporate tax treatment. Desiring to avoid the corporate income tax, however, most limited liability companies with more than one member prefer partnership tax treatment. If a multi-member limited liability company elects corporate tax treatment and qualifies as a "small business corporation," the limited liability company can file a subchapter S election.

The Code generally requires both (i) subchapter C corporations and (ii) partnerships with a subchapter C corporation as a partner to use the accrual method. I.R.C. § 448(a) (2000). Special exceptions, however, apply for qualified personal service corporations and any corporation or partnership that meets a \$5 million gross receipts test. I.R.C. § 448(b)(2)-(3) (2000). Unless the Code treats the partnership as a "tax shelter," a partnership without a subchapter C corporation as a partner can use the cash method. I.R.C. § 448(a)(3) (2000). Similarly, if the Code treats a subchapter S corporation as a "tax shelter," the S corporation cannot use the cash method. *Id.*

¹⁹⁰ In *United States v. Hughes Properties, Inc.*, 476 U.S. 593, 600 (1986), the Supreme Court commented that the "all events" test originated in *United States v. Anderson*, 269 U.S. 422, 441 (1926). See *Gen. Dynamics Corp.*, 481 U.S. at 242. Later, the Treasury Department embodied the test in Treasury Regulation § 1.461-1(a)(2). *Id.* at 243.

¹⁹¹ See *Hughes Props., Inc.*, 476 U.S. at 600 (citing Treas. Reg. § 1.446-1(c)(1)(ii)); see also Treas. Reg. § 1.461-1(a)(2)(i) (as amended in 1999).

¹⁹² Strictly speaking, the Tax Reform Act of 1984 amended the Internal Revenue Code of 1954, as previously amended. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 5(b), 98 Stat. 494, 494.

¹⁹³ Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 91(a), (g), 98 Stat. 494, 598-600, 608 (codified at 26 U.S.C. § 461(h) (2000)).

¹⁹⁴ 26 U.S.C. § 461(h)(4) (2000); see also Treas. Reg. § 1.461-1(a)(2)(i) (as amended in 1999).

as met any earlier than when economic performance with respect to such item occurs.”¹⁹⁵

Section 461 sets forth general principles that govern economic performance when a liability either: (1) requires the taxpayer to provide property or services, or (2) arises either from another person supplying services or property to the taxpayer or from the taxpayer’s use of property.¹⁹⁶ Those general principles, however, specifically do not apply to any “tort liability,” defined as an obligation that both “requires a payment to another person” and “arises out of any tort.”¹⁹⁷ For a “tort liability” economic performance generally occurs when the taxpayer pays the other person.¹⁹⁸ In addition, § 461 explicitly authorizes the Secretary of the Treasury to prescribe regulations that determine when economic performance occurs as to “any other liability.”¹⁹⁹

The Treasury Regulations state that if a taxpayer’s liability arises from “any tort, breach of contract, or violation of law” and requires a payment to another person, economic performance occurs as the taxpayer pays that other person.²⁰⁰

¹⁹⁵ 26 U.S.C. § 461(h)(1) (2000); *see also* Treas. Reg. § 1.461-4 (as amended in 1999). Various exceptions in both the Code and Treasury Regulations, however, limit this general rule. *See infra* notes 185–205 and accompanying text.

¹⁹⁶ I.R.C. § 461(h)(2)(A)–(B) (2000).

¹⁹⁷ I.R.C. § 461(h)(2)(C) (2000).

¹⁹⁸ 26 U.S.C. § 461(h)(2)(C) (2000). The provision also specifically applies to any liability that arises under a workers’ compensation act. 26 U.S.C. § 461(h)(2)(C)(i) (2000). Although Code § 461 provides an exception for certain recurring items, the exception specifically does not apply to “tort liabilities.” 26 U.S.C. § 461(h)(3)(C) (2000). In addition, the Treasury Regulations extend the exclusion from the “recurring item” exception to breaches of contract and violations of law. Treas. Reg. § 1.461-5(c) (as amended in 1995).

Code § 461(h)(2)(C), however, would presumably not apply to an accrued loss arising from the taxpayer’s writeoff of an asset, such as a receivable or investment, because such an accrual would not require “a payment to another person.” 26 U.S.C. § 461(h)(2)(C) (2000).

¹⁹⁹ I.R.C. § 461(h)(2)(D) (2000).

²⁰⁰ Treas. Reg. § 1.461-4(g)(2) (as amended in 1999). Economic performance, however, generally does not occur when the taxpayer makes payments related to a liability to a so-called “third party,” meaning a person other than the person to whom the taxpayer owes the underlying liability. Treas. Reg. § 1.461-4(g)(1)(i) (as amended in 1999). A “third party” includes a trust, escrow account, court-administered fund, or any similar arrangement.

Several exceptions apply to the general rule that payments to a so-called “third party” do not qualify as economic performance. In those situations, economic performance generally occurs as the “third party” makes payments to the person to whom or to which the taxpayer owes the underlying liability. *Id.* In such a scenario, the amount of economic performance may not exceed the amount the taxpayer transferred to the “third party.” *Id.*

First, the person to whom or to which the taxpayer owes the liability can validly assign the right to receive payment to a third party. Treas. Reg. § 1.461-4(g)(1)(iv) (as amended in 1999). In addition, operation of law can accomplish the same result. In either event, a payment to the

Another provision in the Treasury Regulations, which serves as a spillover rule when no revenue ruling, revenue procedure, or other regulation applies and governs so-called "other liabilities," establishes an identical rule.²⁰¹

Under the "economic performance" requirement, therefore, an enterprise cannot deduct, for tax purposes, any amount related to any accrued, but unpaid, expense arising from a tort, breach of contract, or violation of law and that will require payment to another person, until the enterprise actually pays the corresponding liability.²⁰² This rule would apply to accruals for possible damages, anticipated settlements, and perhaps estimated, but unpaid, future legal

third party, or assignee, constitutes payment to the person to whom or to which the taxpayer owes the liability. *Id.*

Second, if the actual or constructive receipt rules would require a cash method taxpayer to recognize income on the transfer, *see supra* note 189, a transaction with a so-called "third party" can qualify as payment to the person to whom or to which the taxpayer owed (again, the "other person"). For example, the purchase of an annuity contract would not constitute payment to the "other person" unless the transaction transfers ownership of the annuity contract to the "other person." Additionally, the regulations exempt qualified settlements of certain personal injury liabilities under Code § 130 and qualified payments to a designed settlement fund under Code § 468B. Treas. Reg. § 1.461-6 (1992).

In addition, the "payment" requirement contemplates that the taxpayer will remit cash, furnish a cash equivalent, or net offsetting accounts. The term "payment" does not include either: (i) delivering the taxpayer's promissory note or other evidence of indebtedness, or (ii) transferring an amount as a loan, refundable deposit, or contingent payment. Treas. Reg. § 1.461-4(g)(1)(ii)(A) (as amended in 1999).

Treasury Regulation § 1.461-4(g)(2) also offers two important clarifications to the rule that economic performance applies as the taxpayer pays the other person. First, the rule applies whenever a taxpayer settles a dispute in which another person alleged a tort, breach of contract, or violation of law. Treas. Reg. § 1.461-4(g)(2)(ii) (as amended in 1999). Second, a liability to make payments for services, property, or other consideration provided under a contract does not qualify as a liability arising from a breach of that contract unless the payments represent incidental, consequential, or liquidated damages. Treas. Reg. § 1.461-4(g)(2)(i) (as amended in 1999).

²⁰¹ Treas. Reg. § 1.461-4(g)(7) (as amended in 1999).

²⁰² Even if a liability arose from a cause of action that did not allege a tort, breach of contract, or violation of law, the obligation would almost certainly fall into the spillover category for "other liabilities." *See supra* note 201 and accompanying text. The Treasury Regulations allow a taxpayer to expense "other liabilities" only as the taxpayer pays the third party. Treas. Reg. § 1.461-4(g)(7) (as amended in 1999). *See, e.g.,* Priv. Ltr. Rul. 97-11-019 (Dec. 11, 1996) (transfer of obligation to pay award on progressive slot machine defaults to liability under Treasury Regulation § 1.461-4(g)(7)). Thus, taxpayers generally cannot deduct, for income tax purposes, accruals for almost all types of litigation until making actual payment. *But see* Treas. Reg. § 1.461-2 (as amended in 1992) (providing an exception when a taxpayer contests an asserted liability and transfers money or other property to allow for the satisfaction of the asserted liability).

fees,²⁰³ related to actions alleging, among other things: personal injury, defamation, product liability, or other torts; breach of warranty or breach of contract, including lease, real estate and government contract disputes; and patent and copyright infringement, securities fraud, or violations of antitrust, employment discrimination, and environmental laws.²⁰⁴ The economic

²⁰³ In some circumstances, an enterprise may accrue amounts for future legal fees that the enterprise expects to incur in resolving a dispute. *See, e.g.,* MESA AIR GROUP, INC., FORM 10-Q, QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF SECURITIES EXCHANGE ACT OF 1934, at 10 (for the quarter ended June 30, 1996) (filed Aug. 14, 1996) (describing a \$10 million special reserve established for the prospective resolution of certain disputed state and federal regulatory tax matters and for the cost of defending certain shareholder lawsuits, specifically including "\$5.7 million for costs of aggressive defense in pending shareholder lawsuits"). As a basic principle, Code § 461 provides that if a liability arises out of the performance of services to the taxpayer, economic performance occurs as such person provides such services. I.R.C. § 461(h)(2)(A)(i) (2000). This rule, however, obviously would not allow a current deduction for future services. In addition, an estimated liability for future legal fees would arguably not satisfy the statutory "all events" test. Until the attorney actually performs the services, all events have not occurred which determine the fact of liability. I.R.C. § 461(h)(4) (2000).

²⁰⁴ In addition, based upon the Supreme Court's decision in *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984), the IRS can presumably still obtain information about accruals for federal income taxes by subpoenaing tax accrual workpapers. *See supra* notes 180-84 and accompanying text. In June 2002, the IRS announced a revised policy concerning when it would request tax accrual workpapers. I.R.S. Announcement 2002-63, 2002-27 I.R.B. 72. During examinations of returns filed prior to July 1, 2002, the revised policy provides that the IRS will request tax accrual workpapers pertaining to a so-called "listed transaction," which refers to various tax shelters, only if the taxpayer had an obligation to disclose the transaction. *Id.* In examinations of returns filed after July 1, 2002, the IRS will request tax accrual workpapers *related to* a listed transaction if the taxpayer disclosed the transaction, but would request *all* tax accrual workpapers if the enterprise did not disclose the listed transaction. *Id.* To lend support to its policy change, the IRS stated that neither the attorney-client privilege nor the tax practitioner privilege protect tax accrual workpapers from such a request. *Id.* Prior to that announcement, however, some commentators wondered about the extent, if any, to which the new accountant-client, or tax practitioner, privilege in non-criminal tax matters may protect those workpapers. *See infra* notes 261-64 and accompanying text. The new privilege applies "to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney." I.R.C. § 7525 (a)(1) (2000). The Conference Committee Report states that a taxpayer can waive the newly created privilege "in the same manner as the attorney-client privilege," and gives disclosure to a third party as an example. H.R. CONF. REP. NO. 105-599, at 269 (1998). Because disclosure to an auditor waives the attorney-client privilege under federal law, the IRS arguably can defeat any claim to the narrower privilege for accountants and other tax preparers. In addition, the Code defines the "tax advice" eligible for the privilege as "advice given by an individual with respect to a matter which is within the scope of the individual's authority to practice [before the IRS]." I.R.C. § 7525(a)(3)(B) (2000). In Announcement 2002-63, the IRS argued that because enterprises and auditors develop tax accrual workpapers to either prepare or audit financial statements, any communications related

performance requirement, however, would not bar the deduction of an expense relating to the writeoff of an asset, such as a receivable.²⁰⁵

Given the limitations on deductibility that the "economic performance" requirement imposes for tax purposes, a litigator can potentially use an opponent's tax returns to determine whether the opponent has accrued any expense, again whether for potential damages, settlement, or attorney's fees, related to or arising from the underlying litigation.²⁰⁶ In particular, Schedule

to those workpapers do not constitute "tax advice." I.R.S. Announcement 2002-63, 2002-27 I.R.B. 72. See generally Bruce Kayle, *The Tax Adviser's Privilege in Transactional Matters: A Synopsis and a Suggestion*, 54 TAX LAW. 509 (2001) (detailing the application of the attorney-client and work product privileges in transactional tax matters and recommending a more restricted application of privilege in tax matters).

²⁰⁵ For example, in late 1994 Procter & Gamble ("P&G") brought a lawsuit against Bankers Trust New York Corp. ("BTNY") and certain subsidiaries (collectively, "Bankers Trust"), alleging that Bankers Trust misled P&G about the risks of investing in certain derivatives contracts. Bankers Trust claimed that P&G owed about \$200 million on two such contracts. P&G's lawsuit asked the court to declare one contract void and sought \$130 million in compensatory damages and unspecified punitive damages from Bankers Trust.

During the third quarter of 1995, BTNY disclosed that it wrote off \$205 million related to leveraged derivative contracts. In discussing this writeoff, BTNY's Form 10-Q for the quarter ending September 30, 1995 stated:

Net charge-offs for the quarter were \$218 million, compared with \$28 million a year ago. The current quarter's net charge-offs included leveraged derivative contract charge-offs of \$205 million against the allowance for credit losses. During the fourth quarter of 1994, \$423 million of leveraged derivative contracts that had been reclassified as receivables in the loan portfolio were placed on a cash basis. Of this amount, \$72 million was then charged-off leaving a balance of \$351 million. Since then some of these receivables have been satisfactorily settled, but in line with the Corporation's credit policies, a \$205 million portion of the remaining balance has been charged-off.

BANKERS TRUST N.Y. CORP., FORM 10-Q, QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934, at 14 (for the quarterly period ended Sept. 30, 1995) (filed Nov. 14, 1995). In May 1996, P&G and Bankers Trust settled the litigation. The Bureau of National Affairs reported that under the settlement P&G agreed both to pay Bankers Trust \$35 million and to assign benefits under a contract that Bankers Trust valued at approximately \$14 million. P&G announced that the company would charge the settlement against a reserve that the company had previously established. In addition, reversing the remaining reserve would increase before-tax earnings by approximately \$120 million. Bankers Trust announced that the settlement would not affect its earnings. *Bankers Trust, P&G Settle Two-Year-Old Lawsuit Surrounding Derivatives Losses*, 28 SEC. REG. & L. REP. (BNA) 635 (1996). Because Bankers Trust charged-off a receivable, the write-off would not appear on Schedule M-1.

²⁰⁶ If the enterprise has accrued some amount, that amount effectively becomes a "floor" for settlement negotiations. In addition, a litigator should attempt to look behind the actual accrual to determine exactly what information management considered before concluding that SFAS No. 5 required an accrual. Such efforts could uncover previously unknown data or

M-1, Reconciliation of Income (Loss) per Books With Income (Loss) per Return, on partnership returns of income, corporation income tax returns, and tax returns for subchapter S corporations generally requires large corporations, limited liability companies, partnerships, and subchapter S corporations to reconcile net income or loss for financial accounting purposes to the income or loss reported on the return.²⁰⁷ For corporations filing a short-form income tax return,²⁰⁸ Part IV, Reconciliation of Income (Loss) per Books With Income per Return, imposes a similar requirement.²⁰⁹ As long as the underlying litigation remains unresolved, the litigation opponent would not have paid amounts corresponding to any financial accounting accruals, except perhaps some portion of the estimated future legal fees.²¹⁰ As a result, if the litigation opponent must complete the

witnesses or reveal that management did not consider an especially damaging fact in its evaluation. *See supra* notes 63–73 and accompanying text.

²⁰⁷ INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 1065, U.S. PARTNERSHIP RETURN OF INCOME 4 (2001); INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 1120, U.S. CORPORATION INCOME TAX RETURN 4 (2001); INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 1120S, U.S. INCOME TAX RETURN FOR AN S CORPORATION 4 (2001). Certain partnerships and corporations need not complete Schedule M-1, however. For partnerships, including limited liability companies classified as partnerships for federal income tax purposes, Form 1065 and related instructions exempt any partnership whose total receipts for the tax year did not equal or exceed \$250,000, whose total assets at the end of the year were less than \$600,000, and that filed Schedules K-1, Partner's Share of Income, Credits, Deductions, etc., with the return and furnished those schedules to the partners on or before the due date, including extensions, for the return. INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 1065, U.S. PARTNERSHIP RETURN OF INCOME 2, 4 (2001). Both the corporation income tax return and the income tax return for subchapter S corporations provide that any corporation, including a limited liability company classified as a corporation for federal income tax purposes, owning less than \$25,000 in total assets need not complete Schedule M-1. INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 1120, U.S. CORPORATION INCOME TAX RETURN 4 (2001); INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 1120S, U.S. INCOME TAX RETURN FOR AN S CORPORATION 4 (2001).

²⁰⁸ In addition to meeting several other requirements, a corporation can file the short form, Form 1120-A, U.S. Corporation Short-Form Income Tax Return, only if the corporation's gross receipts, total income, and total assets each fall below \$500,000. INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, INSTRUCTIONS FOR FORMS 1120 AND 1120-A, at 2 (2001).

²⁰⁹ INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 1120-A, U.S. CORPORATION SHORT-FORM INCOME TAX RETURN 2 (2001). Any corporation, again including a limited liability company classified as a corporation for federal income tax purposes, both eligible to file the short-form and owning less than \$25,000 in total assets need not complete Part IV. *Id.*

²¹⁰ For example, an enterprise might establish an accrual for estimated future legal fees in the first quarter of a fiscal year. By the end of the fiscal year, the enterprise may have actually incurred and paid some of those fees. *See supra* note 203 and accompanying text.

reconciliation, either Schedule M-1 or Part IV, the tax return should reflect an adjustment for any unpaid accruals related to the underlying litigation under SFAS No. 5.²¹¹

Although the various Schedule M-1s for partnership returns of income, corporation income tax returns and tax returns for S corporations and Part IV for corporations filing a short-form return contain slight variations, Line 1 universally requires enterprises completing these reconciliations to state "Net Income (loss) per books."²¹² If prepared properly, after adding and subtracting

²¹¹ See *supra* notes 206–10 and accompanying text. Although the instructions to the partnership return of income, corporation income tax return, corporation short-form income tax return, and income tax return for a subchapter S corporation do not mention accrued, but unpaid contingencies related to litigation, Publication 542 (for 1998 returns), Corporations, presented an example that specifically lists "[r]eserve for contingencies" as an illustrative adjustment. Compare INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, PUBLICATION 542, CORPORATIONS: FOR USE IN PREPARING 1998 RETURNS 12–13 (1998), with INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, INSTRUCTIONS FOR FORM 1065, at 23–24 (1998), INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, INSTRUCTIONS FOR FORMS 1120 AND 1120-A, at 16 (1998), and INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, INSTRUCTIONS FOR FORM 1120S, at 24 (1998); compare also INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, PUBLICATION 542, CORPORATIONS: FOR USE IN PREPARING 2001 RETURNS 17 (2001), with INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, INSTRUCTIONS FOR FORM 1065, at 32 (2001), INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, INSTRUCTIONS FOR FORMS 1120 AND 1120-A, at 20 (2001), and INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, INSTRUCTIONS FOR FORM 1120S, at 26 (2001). The example used in 1998 describes the item as "the difference between the corporation's book and tax basis of its reserve for contingencies." INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, PUBLICATION 542, CORPORATIONS: FOR USE IN PREPARING 1998 RETURNS 13 (1998). In 1999, however, the IRS discontinued this particular example. See INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, PUBLICATION 542, CORPORATIONS: FOR USE IN PREPARING 1999 RETURNS (1999). Interestingly and inexplicably, a sample return for Form 1120, included in Publication 542 for 2001 returns, specifically places reserves for contingencies in Schedule M-2, suggesting that a litigator could determine from Schedule M-2, and any supplemental schedules, whether a litigation opponent has accrued any estimated losses or expenses in anticipation of the underlying litigation. INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, PUBLICATION 542, CORPORATIONS: FOR USE IN PREPARING 2001 RETURNS 17, 22 (2001) (Schedule M-2, line 6: "Other decreases (itemize)"). The IRS seemingly erred when revising its publications.

²¹² INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 1065, U.S. PARTNERSHIP RETURN OF INCOME 4 (2001); INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 1120, U.S. CORPORATION INCOME TAX RETURN 4 (2001); INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 1120S, U.S. INCOME TAX RETURN FOR AN S CORPORATION 4 (2001); INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 1120-A, U.S. CORPORATION SHORT-FORM INCOME TAX RETURN 2 (2001).

In almost all cases, the figure shown on Line 1 should equal the net income or loss that appears on the enterprise's financial statements. An important exception, however, may apply on a consolidated tax return. Consolidated financial statements generally include all

the various line items corresponding to differences between financial and tax accounting, the last line on Schedule M-1 or Part IV also equals the income or loss reported on the tax return.²¹³ The remaining lines itemize the differences between financial accounting net income and tax accounting net income, listing such things as income included on the return, but not recorded on the books this year; expenses, such as travel and entertainment, recorded on the books this year, but not included on the return; income, such as tax-exempt interest, recorded on the books this year, but not included on the return; and deductions, such as depreciation, included on the tax return, but not charged against book income this year.

Depending upon the detail shown in a properly prepared Schedule M-1, or Part IV, a litigator could theoretically determine directly from either the Schedule M-1 or Part IV, and any supplemental schedules, whether a litigation opponent has accrued any estimated losses or expenses related to the underlying litigation without poring through a large number of documents or going through the time and expense of using third-party discovery to obtain any audit workpapers and

majority-owned affiliates, including foreign subsidiaries. CONSOLIDATION OF ALL MAJORITY-OWNED SUBSIDIARIES, Statement of Financial Accounting Standards No. 94 (Financial Accounting Standards Bd. 1987). The Code, however, generally precludes a corporate taxpayer from including a foreign corporation in an affiliated group. I.R.C. § 1504(b)(3) (2000). Thus, the net income or loss per books reported on Line 1 of Schedule M-1 in a consolidated return may not always equal the net income or loss shown on the consolidated financial statements.

When reviewing a consolidated tax return, a litigant must review the separate columnar Schedule M-1s that the Treasury Regulations require for each company in the consolidated group to determine if any consolidated group member's Schedule M-1 contains an adjustment for an accrual related to the underlying litigation. *See* Treas. Reg. § 1.1502-75(j) (as amended in 1994). To illustrate, Merrill Lynch's Form 10-K for the fiscal year ended December 25, 1998 lists fifty-three subsidiaries for the publicly traded parent corporation as of February 24, 1999. MERRILL LYNCH & CO., Exhibit 21 to FORM 10-K, ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (for the fiscal year ended Dec. 25, 1998) (filed Mar. 5, 1999) [hereinafter 1998 MERRILL LYNCH FORM 10-K]. A litigant may need to review the separate Schedule M-1s for each of these subsidiaries to find the desired information.

²¹³ INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 1065, U.S. PARTNERSHIP RETURN OF INCOME 4 (2001) (Schedule M-1, line 9: "Income (loss) (Analysis of Net Income (Loss), line 1)"); INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 1120, U.S. CORPORATION INCOME TAX RETURN 4 (2001) (Schedule M-1, line 10: "Income (line 28, page 1)"); INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 1120S, U.S. INCOME TAX RETURN FOR AN S CORPORATION 4 (2001) (Schedule M-1, line 8: "Income (loss) (Schedule K, line 23)"); INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 1120-A, U.S. CORPORATION SHORT-FORM INCOME TAX RETURN 2 (2001) (Part IV, line 8: "Income (line 24, page 1)").

any other related information.²¹⁴ To the extent, however, that the Schedule M-1, or Part IV, and any supplemental schedules do not provide relevant details, the litigator may have to request additional detail supporting any amounts shown on the line for expenses recorded on the books but not deducted or included on the tax returns for the applicable taxable years.²¹⁵ In addition, a litigant should request and review any income tax audit reports for the tax years in question that may identify audit adjustments arising from the economic performance requirement.²¹⁶

²¹⁴ If either the enterprise or its tax return preparer has omitted, whether inadvertently or intentionally, an adjustment for an accrual related to the underlying litigation that should appear on Schedule M-1 or Part IV, this discovery strategy will probably not uncover that accrual. In addition, even upon audit the IRS may not identify the omission. For these reasons, a litigator should not rely exclusively on tax returns and tax audit reports, if any, to uncover any accruals related to the underlying litigation.

²¹⁵ INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 1065, U.S. PARTNERSHIP RETURN OF INCOME 4 (2001) (Schedule M-1, line 4: "Expenses recorded on books this year not included on Schedule K, lines 1 through 11, 14a, 17g, and 18b (itemize)"); INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 1120, U.S. CORPORATION INCOME TAX RETURN 4 (2001) (Schedule M-1, line 5: "Expenses recorded on books this year not deducted on this return (itemize)"); INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 1120S, U.S. INCOME TAX RETURN FOR AN S CORPORATION 4 (2001) (Schedule M-1, line 3: "Expenses recorded on books this year not included on Schedule K, lines 1 through 11a, 15g, and 16b (itemize)"); INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 1120-A, U.S. CORPORATION SHORT-FORM INCOME TAX RETURN 2 (2001) (Part IV, line 5: "Expenses recorded on books this year not deducted on this return (itemize)").

²¹⁶ The applicable tax audit report depends upon the type of enterprise involved and whether the enterprise agrees with the proposed changes. For partnerships and S corporations, the IRS uses Form 4605, Examination Changes—Partnerships, Fiduciaries, S Corporations, and Interest Charge Domestic International Sales Corporations, for agreed adjustments and Form 4605-A, Examination Changes—Partnerships, Fiduciaries, S Corporations, and Interest Charge Domestic International Sales Corporations, for unagreed adjustments. INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 4605, EXAMINATION CHANGES—PARTNERSHIPS, FIDUCIARIES, S CORPORATIONS, AND INTEREST CHARGE DOMESTIC INTERNATIONAL SALES CORPORATIONS (Rev. Nov. 1986); INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 4605-A, EXAMINATION CHANGES—PARTNERSHIPS, FIDUCIARIES, S CORPORATIONS, AND INTEREST CHARGE DOMESTIC INTERNATIONAL SALES CORPORATIONS (Rev. Sept. 1986). Similarly, the IRS uses Form 4549, Income Tax Examination Changes, for agreed adjustments to tax returns that subchapter C corporations have filed and Form 4549-A, Income Tax Examination Changes, for unagreed adjustments. INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 4549, INCOME TAX EXAMINATION CHANGES (Rev. Nov. 1993); INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, FORM 4549-A, INCOME TAX EXAMINATION CHANGES (Rev. June 1994). At least in unagreed cases involving partnerships and all corporations, the IRS also uses Form 886-A, Explanation of Items, to explain the items adjusted. *See generally* I.R.M. 4237.420(1), .420(2)(u), .531, .541.

In any event, narrowly tailored efforts to discover an enterprise's Schedule M-1 or Part IV, plus any supplemental schedules and related income tax audit reports, should more likely withstand the enterprise's objections to such a discovery request, at least relative to requests to produce the enterprise's books, records, and other financial documents or an auditor's workpapers.²¹⁷ In this regard, a litigant seeking discovery of a tax return solely to review the Schedule M-1 or Part IV and any supplemental schedules or income tax audit reports could quite easily offer to accept the production of a redacted tax return or income tax audit report that hides income amounts and other sensitive information.

Additionally, both the ability to isolate this information in a particular place on a tax return, especially when compared to the unattractive alternative of reviewing voluminous accounting records and numerous audit workpapers, and the level of detail typically present in a tax return, relative to financial statements, offer two other critical advantages over alternative discovery strategies. Because both enterprises preparing financial statements and auditors reviewing them use materiality thresholds, financial statements typically group multiple account balances together. In contrast, an income tax preparer, whether an enterprise's employee or a paid income tax preparer, does not enjoy any such materiality threshold. In most circumstances, two overriding reasons discourage tax return preparers from reporting amounts in large, generalized groupings. First, both tax return preparers and enterprises filing returns typically desire to reduce tax audit risk. Many practitioners believe that providing detailed, low-dollar amount line items gives the IRS less incentive to begin a full-blown audit.²¹⁸ Second, using more detailed line items than found in financial statements typically enables a tax return preparer to save time on preparing the subsequent year's income tax return. Most enterprises that must complete Schedule M-1 or Part IV to reconcile net income or loss for financial accounting purposes to the income or loss reported on the tax return list adjustments that recur from year to year. Most manufacturers, for example, must report adjustments for depreciation and inventories.²¹⁹ Rather than review numerous workpapers every year, a tax return

²¹⁷ See *infra* notes 323–24 and accompanying text.

²¹⁸ One empirical study at least indirectly supports this belief. Using data from IRS Taxpayer Compliance Measurement Programs, the study found that instances of noncompliance increased with the size of a particular line-item. Steven Klepper & Daniel Nagin, *The Anatomy of Tax Evasion*, 5 J.L. ECON. & ORG. 1, 10 (1989). Although various reasons could explain this result, common sense indicates that the IRS would pay closer attention to larger line items, both when selecting returns for audit and when planning an audit.

²¹⁹ Under the accelerated cost recovery system in Code § 168, enterprises can usually claim larger depreciation deductions for tax purposes than they allocate to the current period under the straight line method that most enterprises use to calculate depreciation for financial accounting purposes. I.R.C. § 168 (2000 & Supp. 2002). In contrast, the uniform capitalization rules in Code § 263A require taxpayers to include certain indirect costs in inventory that

preparer can simply look at the prior year's Schedule M-1 or Part IV, and any supplemental schedules, to quickly identify most, if not all, of the necessary adjustments.²²⁰

The litigation between Orange County and Merrill Lynch can help illustrate this concept and discovery technique. Because Merrill Lynch did not pay the \$400 million settlement amount to Orange County until September 1999,²²¹ Merrill Lynch presumably could not deduct amounts that the company had previously accrued until its 1999 tax year. By requesting and carefully examining the Schedule M-1s and any supplemental schedules in Merrill Lynch's tax returns following the filing of its lawsuit, and any related income tax audit reports from the IRS, counsel for Orange County might have uncovered an accrual, either not otherwise discoverable or discoverable only after deposing personnel from Merrill Lynch or its auditor, Deloitte & Touche LLP, or reviewing voluminous accounting records or audit workpapers. To repeat, discovery of such an accrual could have led to other information, such as an important document or potential witness, relevant to the underlying litigation.

Consequently, discovery of Schedule M-1 or Part IV, the corresponding supplemental schedules in an enterprise's tax returns, and any related tax audit reports may enable a litigation opponent to uncover an accrual or other information related to the underlying lawsuit. To date, however, no reported decision has addressed the discoverability of these documents for this purpose,

generally accepted accounting principles would otherwise allow the taxpayer to expense immediately. I.R.C. § 263A (2000). These rules create differences between tax and financial accounting.

²²⁰ Specific general ledger detail accounts often identify Schedule M-1 line items, such as meals and entertainment. *See, e.g.*, I.R.C. § 274(n) (2000) (generally disallowing a tax deduction for fifty percent of meals and entertainment otherwise allowable). The income tax preparer will simply use the detail amounts from the company's general ledger from year to year to complete the relevant line on Schedule M-1.

²²¹ Merrill Lynch's 1998 Form 10-K states:

Under the settlement terms, ML & Co. undertook to pay \$400 million to Orange County [and] approximately \$17 million to Irvine Ranch Water District Payment by ML & Co. will be due approximately five business days after May 3, 1999, the first business day following the expiration of the time for any party to appeal from [the District Court's] finding of good faith[, which bars any potential claims for contribution, indemnity or similar relief by non-settling parties].

1998 MERRILL LYNCH FORM 10-K, *supra* note 212, at 15. Merrill Lynch's Form 10-Q for the quarterly period ended September 24, 1999 states: "In September 1999, Merrill Lynch paid remaining liabilities of \$400 and \$17 plus interest in settlement of the Orange County action and the related Irvine Ranch Water District action, respectively." MERRILL LYNCH & CO., FORM 10-Q, QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934, at 12 (for the quarterly period ended Sept. 24, 1999) (filed Nov. 5, 1999).

and no other commentator has suggested the possibility or the opportunities that Schedule M-1, or Part IV, and related information provides for litigants, especially plaintiffs, during the discovery process.

IV. DISCOVERY OPPORTUNITIES

Collectively, these three developments—the enhanced disclosure rules in Management’s Discussion and Analysis, the Supreme Court’s decision in the *Arthur Young* case, and the addition of the “economic performance” requirement to Code § 461—have fundamentally changed the legal landscape compared to what existed at the time that the legal and accounting professions adopted the 1975 accord. Subject to an important exception for securities litigation,²²² these developments seemingly present both important discovery opportunities for litigators, especially counsel for plaintiffs, and dangerous pitfalls for attorneys representing businesses, especially firms that need audited financial statements. As a result, litigators should recognize the discovery possibilities of obtaining accounting information and supporting data regarding contingencies.

Sophisticated litigators will carefully examine the opponent’s financial statements and securities filings for information about any contingency related to the dispute. In appropriate circumstances, counsel will seek information about relevant contingent liabilities during discovery, by examining the opponent’s books, records, and tax returns or requesting such information from the opponent’s auditor.

Surprisingly few reported decisions, however, address attempts to discover information about litigation reserves. The fact that parties generally cannot appeal discovery orders until the court has entered a final judgment perhaps explains the paucity of appellate opinions.²²³ By that time, the litigants may have either concluded that the legal issues that arose in discovery do not merit

²²² In the Private Securities Litigation Reform Act of 1995, Congress generally imposed a stay of discovery during the pendency of a motion to dismiss or motion for summary judgment in any private action under the federal securities laws. Pub. L. No. 104-67, 15 U.S.C. § 78u-4(b)(3)(B) (2000). *See, e.g.*, *SG Cowen Sec. Corp. v. United States Dis. Court for the N. Dist. of Cal.*, 189 F.3d 909 (9th Cir. 1999) (holding that the district court’s order granting limited discovery for pendent state law claims violated the stay provision); *cf. Tobias Holdings, Inc. v. Bank United Corp.*, 177 F. Supp. 2d 162, 167 (S.D.N.Y. 2001) (granting discovery for independent state law claims when allowing discovery does not represent an “impermissible ‘end run’” around the automatic stay provision).

²²³ Unless the application for discovery constitutes the only pending proceeding, such as when a court in one federal district quashes a subpoena or otherwise denies discovery from a person not a party to an action pending in a different district, neither side can appeal a discovery order, typically an interlocutory order, until the court enters a final judgment. 8 CHARLES A. WRIGHT ET AL., *FEDERAL PRACTICE AND PROCEDURE* § 2006, at 76 (2d ed. 1994) (discussing the general rule and some limited exceptions).

pursuing on appeal or decided to base any appeal on other issues. The surprisingly small number of reported decisions that address these issues, however, suggests that litigators rarely request accounting information related to contingencies or working papers. Some litigators may decide that the expected benefits from such data do not outweigh the costs to obtain the information. Many litigators, however, do not know that this information exists or underestimate its strategic and practical value. Before requesting any information regarding contingencies from a litigation opponent, smart litigators will consider whether an opponent can request similar information from their client. In this regard, attorneys representing individuals, especially tort plaintiffs, governmental bodies and agencies, and businesses that do not require audited financial statements generally need not worry about this downside. Discovery disputes, however, can become expensive and time-consuming.

A. General Scope of Discovery

After recent amendments effective December 1, 2000, Rule 26(b)(1) of the Federal Rules of Civil Procedure generally allows parties to “obtain discovery regarding any matter, not privileged, that is relevant to the claim or defense of any party” Stated simply, a party can discover relevant, non-privileged information. Several important legal defenses, however, affect a litigant’s ability to obtain discovery during litigation. These legal issues include legal relevancy, the attorney-client privilege, the work product doctrine, and in some states, the accountant-client privilege.

1. Relevancy

Rule 26(b)(1) generally allows a party to obtain any relevant information from both other parties and nonparties during discovery. While discussing an earlier version of that rule, the Supreme Court stated that the relevancy requirement “has been construed broadly to encompass any matter that bears on, or that reasonably could lead to other matter that could bear on, any issue that is or may be in the case.”²²⁴ In addition, Rule 26(b)(1) specifically states that “[r]elevant information need not be admissible at the trial if the discovery appears reasonably calculated to lead to the discovery of admissible

²²⁴ *Oppenheimer Fund, Inc. v. Sanders*, 437 U.S. 340, 351 (1978) (citing *Hickman v. Taylor*, 329 U.S. 495, 499–501 (1957), and an earlier version of *WRIGHT ET AL.*, *supra* note 223); *see also* *Food Lion, Inc. v. United Food & Commercial Workers Int’l Union, AFL-CIO-CLC*, 103 F.3d 1007, 1012 (D.C. Cir. 1997) (“Generally speaking, ‘relevance’ for discovery purposes is broadly construed.”).

evidence.”²²⁵ Significantly, the last sentence in Rule 26(b)(1) explicitly directs courts to construe the relevancy requirement more loosely during the discovery phase than at trial, when the Federal Rules of Evidence apply.²²⁶ As a result, information need not be admissible to be discoverable. Rule 26(b)(1) presumably applies the same standard to discovery requests directed to both parties and nonparties.²²⁷

Under this expansive interpretation, a federal district court or state trial court following rules similar to the Federal Rules of Civil Procedure could easily conclude that information related to litigation reserves, whether financial statements, books and records,²²⁸ tax returns,²²⁹ audit workpapers,²³⁰ audit

²²⁵ FED. R. CIV. P. 26(b)(1). That subdivision provides in its entirety:

(b) Discovery Scope and Limits. Unless otherwise limited by order of the court in accordance with these rules, the scope of discovery is as follows:

(1) In General. Parties may obtain discovery regarding any matter, not privileged, that is relevant to the claim or defense of any party, including the existence, description, nature, custody, condition, and location of any books, documents, or other tangible things and the identity and location of persons having knowledge of any discoverable matter. For good cause, the court may order discovery of any matter relevant to the subject matter involved in the action. Relevant information need not be admissible at the trial if the discovery appears reasonably calculated to lead to the discovery of admissible evidence. All discovery is subject to the limitations imposed by Rule 26(b)(2)(i), (ii), and (iii).

Id. As discussed, *infra* at notes 323–24 and accompanying text, the last sentence gives a judge discretion to limit the number of interrogatories and depositions when the judge deems the request “unreasonably cumulative or duplicative,” where the party seeking discovery had ample opportunity to obtain the information, or where the burden of the request outweighs its benefit, respectively. FED. R. CIV. P. 26(b)(2).

²²⁶ See WRIGHT ET AL., *supra* note 223, § 2008, at 99–100. Rule 401 of the Federal Rules of Evidence defines relevant evidence for purposes of admissibility at trial. FED. R. EVID. 401.

²²⁷ See, e.g., *Fein v. Numex Corp.*, 92 F.R.D. 94, 96 (S.D.N.Y. 1981) (“Rule 26(b) of the Federal Rules of Civil Procedure limits discovery to relevant matters, and makes no distinction in this regard between information in the hands of parties and that held by nonparties.”).

²²⁸ Some courts, however, have refused to permit a party to discover information pertaining to reserves that enterprises, especially insurance companies, may have set aside to satisfy future claims. See, e.g., *Nat’l Union Fire Ins. Co. v. Stauffer Chem. Co.*, 558 A.2d 1091, 1091 (1989) (denying request to produce information related to reserves on relevancy grounds because the fact that insurance company had established reserves did not necessarily mean that insurer believed applicable policies would cover hazardous waste claims).

²²⁹ In protecting the privacy of tax returns on other grounds, courts have often recognized, at least implicitly, the relevance of tax returns. See FED. R. CIV. P. 26 advisory committee’s note to 1970 amendment to subdivision (b).

²³⁰ See, e.g., *In re Diasonics Sec. Litig.*, Case No. C-83-4584-RFP(FW), 1986 WL 53402 (N.D. Cal. 1986). In that case, plaintiffs filed a motion to compel Arthur Young & Co. to

inquiry letters,²³¹ or information related to any investigation by the now-defunct Public Oversight Board qualifies as "relevant" in almost any case. In addition,

produce documents prepared by or disclosed to Diasonics' auditor so that the accounting firm could assess how pending litigation, including the underlying lawsuit, would affect Diasonics' financial condition. The court granted the motion, finding that neither the attorney-client privilege nor the work product doctrine excused production because the documents "were generated for the business purpose of creating financial statements which would satisfy the requirements of the federal securities laws and not to assist in litigation." *Id.* at *1. The court reasoned, at least in part, that although disclosure to someone sharing a common interest under a guarantee of confidentiality does not necessarily waive the work product protection, an independent accountant's responsibilities to creditors and the investing public transcend any such guarantee.

²³¹ With one exception, the recent reported cases have ordered discovery of audit inquiry letters. *Compare* *United States v. Gulf Oil Corp.*, 760 F.2d 292 (Temp. Emer. Ct. App. 1985); *Indep. Petrochemical Corp. v. Aetna Cas. & Sur. Co.*, 117 F.R.D. 292 (D.D.C. 1987), and *In re Hillsborough Holdings Corp.*, 132 B.R. 478 (Bankr. M.D. Fla. 1991) (all granting motions to compel production of letters which attorneys sent to public accounting firms), *with* *Tronitech, Inc. v. NCR Corp.*, 108 F.R.D. 655 (S.D. Ind. 1985) (denying motion to compel discovery of audit inquiry letter).

Perhaps most significantly, in a sealed opinion arising from a grand jury investigation and subpoena involving Drexel Burnham Lambert Inc., the United States District Court for the Southern District of New York reportedly held that disclosures about potential litigation in an audit inquiry letter from outside counsel waived both the attorney-client privilege and the work product protection as to the underlying information. Breckinridge L. Willcox, Martin Marietta and the Erosion of the Attorney-Client Privilege and Work-Product Protection, 49 MD. L. REV. 917, 935-39 (1990). *The National Law Journal* published a story that stated that Senior District Judge Edmund L. Palmieri ordered the company's attorneys to produce certain materials that they used to write letters to auditors outlining the case's status and merits and held two prominent lawyers in contempt when they failed to do so. Sherry R. Sontag, *Sealed Order Still Haunts Defense Bar*, NAT'L L.J., Jan. 9, 1989, at 1; *see also* Subcomm. on Audit Inquiry Responses, Section of Bus. Law, A.B.A., *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretation AU Section 337*, 45 BUS. LAW. 2245, 2248 (1990).

More recently, Judge John Martin of the same court granted a motion to compel that plaintiffs in a securities fraud case pending in federal court in Florida involving Sensormatic Electronics Corp. filed against third party Willkie Farr & Gallagher, a leading New York law firm. The motion to compel sought certain documents relating to an investigation that the law firm conducted on behalf of Sensormatic's audit committee. The audit committee had disclosed the results of the investigation to Ernst & Young, the company's auditing firm, to obtain an unqualified audit opinion. The court held that this disclosure waived the attorney-client privilege. *In re Subpoena Duces Tecum Served on Willkie Farr & Gallagher*, No. M8-85 (JSM), 1997 WL 118369 (S.D.N.Y. Mar. 14, 1997).

One recent article suggests that the work product doctrine does protect audit-inquiry responses. Sharp & Stanger, *supra* note 19. In their article, Sharp and Stanger criticize cases compelling discovery of audit-inquiry responses for misinterpreting the work product doctrine. *Id.* at 202-09 (discussing *United States v. Gulf Oil Corp.*, 760 F.2d 292 (Temp. Emer. Ct. App.

because most punitive damages awards depend, at least in part, upon the defendant's financial condition, most courts would likely hold that financial statements qualify as relevant to the issue of punitive damages and, therefore, allow discovery.²³² Similarly, in any lawsuit in which a party seeks to disgorge business damages, a court would almost certainly allow discovery of the opposing party's financial statements.²³³

Because litigation contingencies represent accruals or disclosures related to a specific claim in a lawsuit, the supporting materials related to litigation contingencies almost by definition represent materials "relevant to the claim or defense." Audit workpapers, for example, may reveal the enterprise's estimate of a contingent liability, data which the business used to compute the estimate, or other information which the auditor gathered to verify the appropriateness of the

1985); *Indep. Petrochemical Corp. v. Aetna Cas. and Sur. Co.*, 117 F.R.D. 292 (D.D.C. 1987); *Sealed Drexel Case*, discussed in *Sontag*, *supra*, at 3; *In re Hillsborough Holdings Corp.*, 132 B.R. 478 (Bankr. M.D. Fla. 1991); *In re Grand Jury Proceedings (Under Seal)*, 33 F.3d 342 (4th Cir. 1994)). Citing three recent cases that support their proposition, two of which related to documents other than audit-inquiry responses, Sharp and Stanger conclude that courts should interpret the work product doctrine as offering protection to audit-inquiry responses, which are prepared because of litigation, and therefore not in the regular course of business. *Id.* at 204, 209–11 (discussing *Tronitech, Inc. v. NCR Corp.*, 108 F.R.D. 655 (S.D. Ind. 1985); *Vanguard Sav. & Loan Ass'n v. Banks*, No. 93-CV-4627, 1995 U.S. Dist. LEXIS 13712 (E.D. Pa. 1995) (ordering discovery of audit-inquiry-like responses); *United States v. Adlman*, 134 F.3d 1194 (2d Cir. 1998) (ordering discovery of documents that assessed the desirability of a business transaction based on the anticipated result of expected litigation)). Sharp and Stanger, however, admit that they bias their argument in favor of work product protection, and come to their conclusion based on the interpretation of a small number of courts, discussing three cases that protected audit-inquiry, or audit-inquiry-like, responses from discovery, and five that compelled discovery. *Id.* at 201–11. The one case involving an audit inquiry response that does support their argument, *Tronitech, Inc.*, 108 F.R.D. at 655 (described *supra* in this note), does not cite *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984). See *supra* notes 180–84 and accompanying text.

²³² See, e.g., *Oakes v. Halvorsen Marine Ltd.*, 179 F.R.D. 281 (C.D. Cal. 1998) (holding that defendants asserting a counterclaim for punitive damages could obtain discovery regarding the plaintiff's net worth); *Caruso v. Coleman Co.*, 157 F.R.D. 344 (E.D. Pa. 1994) (holding that financial statements were relevant and discoverable as to the issue of punitive damages).

²³³ See, e.g., *Upchurch v. USTNET, Inc.*, 158 F.R.D. 157 (D. Or. 1994) (holding that because defendant's counterclaim alleged destruction of business, plaintiff could obtain information regarding defendant's financial status); *In re Folding Carton Antitrust Litig.*, 76 F.R.D. 420 (N.D. Ill. 1977) (holding that manufacturers were entitled to copies of financial statements as the information might be relevant to damages). See note 170, *supra*, and accompanying text for a discussion of the relevancy for discovery purposes of the underlying workpapers related to litigation contingencies.

enterprise's treatment.²³⁴ Such information bears on, or reasonably could bear on, an issue potentially involved in the litigation, such as liability or damages, and could easily lead to potential witnesses, helpful documents, or other

²³⁴ When a litigant requests the production of documents or other discovery from an adversary's auditor, whether the request seeks working papers generally, information about specific contingencies, or responses to audit letters to attorneys, numerous tensions arise. First, the auditor must decide how to respond. As a practical matter, in most cases the auditor wants to keep the client happy so that the client remains a client. Because working papers usually provide the easiest roadmap to the client's business organization and financial statements, the client almost always prefers that the auditor not produce the working papers. In addition, the client normally does not want the auditor to release any information relating to specific contingencies or responses to audit inquiry letters. At least in the case of a SEC registrant, however, the client cannot simply dismiss an auditor that decided to produce working papers, information about specific contingencies, management's letter, a response to an audit letter to an attorney, or other data, or otherwise comply with a discovery request, without any potentially negative repercussions. Item 304(a) of Regulation S-K, 17 C.F.R. § 229.304(a) (2002), or for a small business issuer, Item 304(a) of Regulation S-B, 17 C.F.R. § 228.304(a) (2002), require a registrant to report on Form 8-K within five business days and disclose in periodic filings and certain other documents for two years certain information if the registrant dismisses an auditor or the auditor resigns or declines to stand for reelection. The regulations require the former auditor to submit a letter to the SEC, which the registrant must file within ten business days after filing Form 8-K, but within two days after the registrant receives the letter from the former auditor, either concurring or disagreeing with the statements contained in the Form 8-K. As no surprise, the financial community views changes in auditors after almost any dispute with considerable suspicion.

At the same time, the auditor must fulfill conflicting legal and professional responsibilities. These obligations require the auditor to comply with legitimate discovery requests, preserve client confidences, protect possible proprietary information about the auditor's procedures, and maintain independence. In such situations, auditors sometimes simply ignore the production request. Such an approach forces the requesting party to file a motion to compel, but can result in sanctions against the auditor under Rule 37 of the Federal Rules of Civil Procedure. *See* Rothschild & McKenna, *supra* note 19, at 405–07. As a more preferable alternative, the auditor can move for a protective order and attempt to quash the subpoena. In either event, the requesting party must decide whether to incur the costs necessary to serve and then to enforce a third party subpoena in an action usually separate from the underlying litigation.

If the requesting party decides to try to enforce a third party subpoena, unless and until the court allows the client to intervene, the client does not become a party in that dispute and must view the proceedings as a spectator. To illustrate, if requesting party B tries to enforce a subpoena against accountant A to obtain documents relating to client C, legally speaking the enforcement action does not involve C. This situation also creates some practical concerns for C's counsel. Even if C intervenes in the dispute between B and A, C's counsel does not represent A. As a result, any communications between C's counsel and A or A's counsel do not qualify for the attorney-client privilege.

admissible evidence.²³⁵ Estimates of damages, probability measurements, underlying facts, and attorney opinions and communications all exemplify the types of information accounting personnel use to determine the financial statement treatment of a litigation contingency; if nothing else, all these sources of information represent materials related to a specific claim and should therefore represent materials "relevant" under Rule 26(b)(1).

Either a party or nonparty may challenge a request for any accounting information created after the underlying incident or commencement of the action on the grounds that the request seeks information about matters arising after the incident or the action's commencement. Although cases exist in which courts have limited discovery to matters arising prior to the commencement of the action, events occurring after that time can qualify as relevant. For this reason, most commentators correctly reject any rule that limits discovery to matters occurring before the action's commencement. In addition, or alternatively, a nonparty, such as an auditor, may attempt to quash the discovery request on relevancy grounds.²³⁶ Several courts, however, have appropriately concluded that nonparties may not assert lack of relevancy.²³⁷

2. Absence of Privilege

Rule 26(b)(1) prevents a party from discovering privileged material.²³⁸ As recently as *Jaffee v. Redmond*,²³⁹ the Supreme Court has stated that it disfavors claims of privilege. Against that backdrop, two potential privileges exist: the attorney-client privilege and the accountant-client privilege. Except in non-criminal tax cases, federal common law does not recognize an accountant-client privilege.

²³⁵ See, e.g., *United States v. Arthur Young & Co.*, 465 U.S. 805, 820 n.16 (1984) (dicta); *Indep. Petrochemical Corp. v. Aetna Cas. & Sur. Co.*, 117 F.R.D. 292 (D.D.C. 1987) (accepting Insurance Company of North America's contention that audit letters could lead to admissible evidence bearing on various defenses that the insurance company had raised).

²³⁶ See, e.g., *Food Lion, Inc. v. United Food & Commercial Workers Int'l Union, AFL-CIO-CLC*, 103 F.3d 1007 (D.C. Cir. 1997) (vacating an order compelling a third-party public relations firm to produce fourth-party union documents because the district court erred in holding the documents were relevant for discovery purposes).

²³⁷ See, e.g., *Benetz v. Photon, Inc.*, 21 Fed. R. Serv. 2d (Callaghan) 791 (D. Mass. 1975) (refusing to consider an irrelevancy objection from Arthur Young and Company to a deposition ancillary to an action pending in the Eastern District of Pennsylvania); *Cooney v. Sun Shipbuilding & Drydock Co.*, 288 F. Supp. 708, 717 (E.D. Pa. 1968); see also *Berrie v. Berrie*, 457 A.2d 76 (N.J. Super. Ct. Ch. Div. 1983) (applying state rule).

²³⁸ FED. R. CIV. P. 26(b)(1) (allowing discovery of materials "not privileged").

²³⁹ 518 U.S. 1 (1996).

a. Attorney-Client Privilege

In most discovery disputes over accounting information regarding contingencies generally, and audit inquiry letters in particular, the attorney-client privilege does not apply. In the first place, no confidential communication between an attorney and the client exists. If internal accounting employees receive such communications for purposes of preparing financial statements, the communication often does not satisfy the "legal advice" requirement, and the privilege likely will not attach. For example, in *Simon v. G.D. Searle & Co.*,²⁴⁰ the court stated that "attorney-to-client communications reflected in the risk management documents" were not protected by the attorney-client privilege.²⁴¹ The court found that the aggregate risk documents did not contain privileged communications "to a degree that makes the aggregate information privileged."²⁴² Although the court's decision related only to the aggregate risk management documents, it did at least mention the possibility that even those communications related to the individual case reserves might have lost any attorney-client privilege.²⁴³

Second, disclosing such a communication to a third party, such as the client's auditor, normally waives the privilege.²⁴⁴ Even if the attorney-client privilege did apply to certain communications, the client—or possibly even the attorney—can waive the privilege. Waiver occurs typically where a party discloses voluntarily otherwise privileged attorney-client communications, such as in a proxy statement or other securities filing.²⁴⁵ In the context of discovery of

²⁴⁰ 816 F.2d 397 (8th Cir. 1987).

²⁴¹ *Id.* at 403.

²⁴² *Id.*

²⁴³ *Id.* at 403 n.5 (stating no view whether the privilege attached to the individual case reserves, but adding that such a determination would require analysis of whether management used "confidential information" to calculate the reserves).

²⁴⁴ See, e.g., *In re Horowitz*, 482 F.2d 72, 81 (2d Cir. 1973) (subsequent disclosure to accountant waived attorney-client privilege); see also *United States v. Mass. Inst. of Tech.*, 129 F.3d 681 (1st Cir. 1997) (holding that MIT forfeited both the attorney-client privilege and work product protection by disclosing documents sought by the IRS to the Defense Contract Audit Agency, the auditing arm of the Department of Defense, during a performance review on certain defense contracts and joining five other circuits, out of the six other circuits that have considered the question, in concluding that earlier disclosure at the request of government agency destroys the privilege).

²⁴⁵ See *United States v. Workman*, 138 F.3d 1261, 1263 (8th Cir. 1998); 8 WRIGHT ET AL., *supra* note 223, § 2016.2.

One recent decision, *In re Pioneer Hi-Bred Int'l, Inc.*, 238 F.3d 1370 (Fed. Cir. 2001), suggests that proxy statement disclosures waive the attorney-client privilege. In that case, Pioneer asked outside counsel to provide an opinion concerning the tax consequences of a

an enterprise's documentation concerning SFAS No. 5 determinations, disclosure of the information outside of the confidential relationship represents the most likely source of waiver of the privilege because disclosure to the auditors, or to a financial analyst or investment banker, defeats the existence of confidentiality between the attorney and the client.²⁴⁶

Disclosure to internal accounting personnel might constitute waiver, especially when the disclosure arose from financial statement preparation, as opposed to where the disclosure occurred in the context of obtaining legal advice. In addition, the fact that accounting personnel receive such documentation to support disclosures to third party financial statement readers (either the public or creditors) might constitute a waiver of the privilege. Assuming accounting personnel ultimately use otherwise confidential information from the enterprise's attorney that indicates a "probable" (in the SFAS No. 5 sense) loss in a lawsuit, the enterprise has at least indirectly disseminated the information related to litigation contingencies by way of the financial statements. In other words, if the financial statements include an accrued liability for a lawsuit, the enterprise has, in effect, disclosed that its management—and possibly its attorney—determined that a "probable" loss exists.²⁴⁷ Even when the financial statement footnotes merely disclose pending litigation, the mention means management has determined that a better than remote chance exists that the enterprise may incur a loss.²⁴⁸ One could therefore argue that the enterprise has—by way of its financial statements—disclosed

proposed merger, which Pioneer intended to include in its proxy statement. *Id.* at 1373. The court held that Pioneer's reliance on and disclosure of outside counsel's opinion in its proxy statement waived the attorney-client privilege, but only with respect to the documents that formed the basis for the advice, the documents that outside counsel considered when it rendered that advice, and all reasonably contemporaneous documents that reflected discussions concerning that advice. *Id.* at 1374–75. The *Pioneer* court did not rule on the issue of work product protection, finding the record insufficient to make such a ruling. The court did, however, rule that Pioneer's disclosure of confidential information to expert witnesses waived both the attorney-client privilege and work product protection to the same extent as any other disclosure. *Id.* at 1375–76.

²⁴⁶ See, e.g., *United States v. El Paso Co.*, 682 F.2d 530, 540 (5th Cir. 1982) (concluding no privilege because "[c]onfidentiality . . . is neither expected nor preserved, for they are created with the knowledge that independent accountants may need access . . . to complete the audit"); *United States v. Rosenthal*, 142 F.R.D. 389, 392 (S.D.N.Y. 1992) (stating no privilege where materials communicated to attorney with understanding that it will be communicated to accountants eliminates requisite confidentiality); *Indep. Petrochemical Corp. v. Aetna Cas. & Sur. Co.*, 117 F.R.D. 292, 297 (D.D.C. 1987) (documents written for accountants not privileged due to disclosure).

²⁴⁷ See *supra* notes 36–43, 49 and accompanying text.

²⁴⁸ See *supra* text accompanying notes 54 and 73.

otherwise confidential conclusions regarding the lawsuit and therefore waived any attorney-client privilege.

Although no cases deal directly with this argument, two cases that considered closely related matters provide some insight. In *Carey-Canada, Inc. v. California Union Insurance Co.*,²⁴⁹ the court considered whether the attorney-client privilege applied to in-house counsel's documents related to his efforts to prepare the corporation's litigation footnotes in its annual report.²⁵⁰ The documents consisted of drafts of the final footnote disclosures that the in-house counsel forwarded to the corporation's management for final approval.²⁵¹ Noting that the drafts related to a public document, the court nevertheless held the attorney-client privilege applied to the documents.²⁵² Stating that the documents "were submitted to [management] for approval and thus only were recommendations," the court found that the company's management preserved the confidentiality due to the retention of an "option to reject disclosure of any advice or information."²⁵³

On somewhat different facts, the court in *In re Grand Jury Proceedings*²⁵⁴ held that the attorney-client privilege did not apply to communications that an attorney planned to use for drafting a prospectus.²⁵⁵ The clients intended the prospectus to relate to a proposed private placement of limited partnership interests in coal-mining equipment leases, but within two weeks of retaining the attorney, the clients discontinued his services.²⁵⁶ The court compelled disclosure of the communications in which the attorney took part although he never began work on the prospectus itself.²⁵⁷ The court found that the "[t]he significant fact is that the information given the [attorney] was to assist in preparing such prospectus which was to be published to others and was not intended to be kept in confidence."²⁵⁸

Although neither the *Carey-Canada* court nor the *Grand Jury* court considered the implication of indirect disclosure, they both indicate that courts will typically focus on the relationship between the purportedly privileged

²⁴⁹ 118 F.R.D. 242 (D.D.C. 1986).

²⁵⁰ See *id.* at 246.

²⁵¹ *Id.*

²⁵² *Id.* at 247-48.

²⁵³ *Id.* The court also noted that "[t]he fact that communications" originated from the attorney did not affect the privilege because the communications were based upon confidential information provided by the client. *Id.* at 248.

²⁵⁴ 727 F.2d 1352 (4th Cir. 1984).

²⁵⁵ *Id.* at 1358.

²⁵⁶ *Id.* at 1353-54.

²⁵⁷ *Id.* at 1358.

²⁵⁸ *Id.*

information and the final form of disclosure. One can view the *Carey-Canada* decision as resting on the fact that the drafts reflected the attorney's "legal opinion as to what information should be disclosed."²⁵⁹ The court might have reached a different conclusion had the attorney's opinions not affected the final form of disclosure except to the extent accounting personnel considered the attorney's opinions in their SFAS No. 5 analysis. A *Grand Jury* court might also find that such indirect disclosures waive the privilege as to the underlying information because the public nature of the disclosures reveals no intention to keep the information confidential.²⁶⁰

b. Accountant-Client Privilege

Apart from a narrow accountant-client privilege found in the Internal Revenue Code, no accountant-client privilege exists under either federal law or the common law.²⁶¹ As a result, federal courts do not recognize an accountant-client privilege in any non-tax case involving, in whole or in part, a federal claim.²⁶² With different degrees of success, however, businesses in state court proceedings have attempted to assert the accountant-client privilege to prevent litigation opponents from discovering workpapers and other documents which their employees or independent auditor created. At least thirty states have

²⁵⁹ *Carey-Canada, Inc. v. Cal. Union Ins. Co.*, 118 F.R.D. 247, 247 (D.D.C. 1986).

²⁶⁰ See, e.g., *In re Hillsborough Holdings Corp.*, 118 B.R. 866, 870 (Bankr. M.D. Fla. 1990) (finding that underlying information related to attorney opinion letter was not privileged).

²⁶¹ 23 CHARLES A. WRIGHT & KENNETH W. GRAHAM, JR., *FEDERAL PRACTICE AND PROCEDURE* § 5427 (1980 & Supp. 1995). In *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984), the Supreme Court observed that "no confidential accountant-client privilege exists under federal law." *Id.* at 817 (quoting *Couch v. United States*, 409 U.S. 322, 335 (1973)).

²⁶² See, e.g., *Wm. T. Thompson Co. v. Gen. Nutrition Corp.*, 671 F.2d 100, 104 (3d Cir. 1982) (holding that federal law favoring admissibility, rather than any state law privilege, controlled in a case involving antitrust and state law claims). In federal courts, issues relating to the accountant-client privilege arise only in civil tax cases and diversity cases. In the IRS Restructuring and Reform Bill of 1998, Pub. L. No. 105-206, 3411(a), 112 Stat. 685, 750 (codified at I.R.C. § 7525 (2000)), Congress recently created an accountant-client privilege in civil tax matters either before the IRS or in federal courts. That legislation, however, does not protect accountant-client communications from disclosure in other contexts and does not change the "ability of any other regulatory body, including the [SEC], to gain or compel information." S. REP. NO. 105-174, at 71 (1998), reprinted in 1998 TAX LEGISLATION: LAW, EXPLANATION AND ANALYSIS: IRS RESTRUCTURING AND REFORM ACT OF 1998 (CCH) 618. The accountant-client privilege can also apply when state privilege law provides the rule of decision under the *Erie* doctrine.

enacted a statutory accountant-client privilege.²⁶³ Again, even in those states that recognize an accountant-client privilege, the privilege requires a confidential communication. In addition, disclosing information regarding the subject matter of the communication to third parties, such as financial analysts or investment bankers, presumably waives the privilege.²⁶⁴

B. Other Defenses to Discovery Requests or Limitations on the Scope of Discovery

In addition to lack of relevancy and privilege, the work product doctrine may protect information related to litigation reserves and contingencies from discovery. The work product protection, however, only applies to materials "prepared in anticipation of litigation or for trial" and does not apply to materials prepared in the ordinary course of business. Finally, either a party or a third party can seek a protective order from unreasonably cumulative, burdensome, or expensive discovery requests.

1. Work Product

Rule 26(b)(3) of the Federal Rules of Civil Procedure recognizes the so-called work product doctrine, which generally excepts trial preparation materials from discovery.²⁶⁵ The work product doctrine, however, only applies to materials

²⁶³ A recent decision of the Supreme Court of Colorado notes that "[a]t least thirty states have codified some form of protection for communications between an accountant and a client." *Colo. State Bd. of Accountancy v. Zaverl Boosalis Raisch*, 960 P.2d 102, 106 n.3 (Colo. 1998) (listing applicable statutes). A recent law review note suggests that the recognition of a federal psychotherapist-patient privilege in *Jaffee v. Redmond*, 518 U.S. 1 (1996), opens the door to new arguments that the federal judiciary should recognize an accountant-client privilege in federal matters. The article, however, ultimately concludes that even under the new and broader approach to granting privileges espoused in the recent decision, the federal system will not recognize an accountant-client privilege until more states recognize meaningful accountant-client privileges. Thomas J. Molony, Note, *Is the Supreme Court Ready to Recognize Another Privilege? An Examination of the Accountant-Client Privilege in the Aftermath of Jaffee v. Redmond*, 55 WASH. & LEE L. REV. 247 (1998).

²⁶⁴ See *supra* notes 244-48 and accompanying text.

²⁶⁵ Rule 26(b) provides in pertinent part:

(b) Discovery Scope and Limits. Unless otherwise limited by order of the court in accordance with these rules, the scope of discovery is as follows:

....

(3) Trial Preparation: Materials. Subject to the provisions of subdivision (b)(4) of this rule, [which addresses trial preparation of experts,] a party may obtain discovery of documents and tangible things otherwise discoverable under

“prepared in anticipation of litigation or for trial” and does not apply to materials prepared in the ordinary course of business or otherwise for some purpose not primarily concerned with litigation. Because enterprises often undergo annual audits, the response to an audit inquiry letter probably falls in “the ordinary course of business” category.²⁶⁶

Federal Rule of Civil Procedure 26(b)(3) codifies the Supreme Court’s formulation of immunity to an attorney’s “written statements, private memoranda and personal recollections prepared or formed . . . in the course of his legal duties.”²⁶⁷ The Rule protects “documents and tangible things . . . prepared in anticipation of litigation or for trial by or for another party or by or for that other party’s representative.”²⁶⁸ The Rule protects such materials by providing a requirement that an opposing party that seeks the information must: (1) show a “substantial need” for the materials; and (2) prove that the party cannot obtain the “substantial equivalent” by other means without “undue hardship.”²⁶⁹ Even when the party seeking discovery has made such a showing, the Rule requires the court to “protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation.”²⁷⁰

subdivision (b)(1) of this rule and prepared in anticipation of litigation or for trial by or for another party or by or for that other party’s representative (including the other party’s attorney, consultant, surety, indemnitor, insurer, or agent) only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of the party’s case and that the party is unable without undue hardship to obtain the substantial equivalent of the materials by other means. In ordering discovery of such materials when the required showing has been made, the court shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation.

FED. R. CIV. P. 26(b)(3).

²⁶⁶ See, e.g., *United States v. Gulf Oil Corp.*, 760 F.2d 292 (Temp. Emer. Ct. App. 1985); *Indep. Petrochemical Corp. v. Aetna Cas. & Sur. Co.*, 117 F.R.D. 292 (D.D.C. 1987); *In re Hillsborough Holdings Corp.*, 132 B.R. 478 (Bankr. M.D. Fla. 1991) (all rejecting arguments that letters which attorneys sent to public accounting firms qualified for work product protection); see also Melissa D. Shalit, Note, *Audit Inquiry Letters and Discovery: Protection Based on Compulsion*, 15 CARDOZO L. REV. 1263 (1994) (arguing that the work product doctrine probably does not protect audit inquiry letters from discovery unless the enterprise can successfully assert that compulsion forced any disclosure).

²⁶⁷ *Hickman v. Taylor*, 329 U.S. 495, 510 (1947).

²⁶⁸ FED. R. CIV. P. 26(b)(3).

²⁶⁹ *Id.*

²⁷⁰ *Id.*

Courts use the work product doctrine to “preserve[] the privacy of preparation that is essential to the attorney’s adversary role.”²⁷¹ Because materials an attorney creates will often represent opinions and legal theories, the doctrine gives “virtually absolute protection”²⁷² to such materials to prevent an opposing party from accessing these mental processes.²⁷³ Yet, all of these protections remain subject to one major qualification: a party must have prepared the documents “in anticipation of litigation or for trial.”²⁷⁴

a. *Courts’ Interpretations of “In Anticipation of Litigation”*

Although the definition of “in anticipation of litigation” varies from court to court,²⁷⁵ the Advisory Committee’s note to the amendment to Rule 26(b)(3) in 1970 stated that “[m]aterials assembled in the ordinary course of business, or pursuant to public requirements unrelated to litigation, or for other nonlitigation purposes are not under the qualified immunity.”²⁷⁶ Although sometimes called the “ordinary course of business exception,”²⁷⁷ the concept does not so much create an exception to otherwise protected materials as it merely deems the materials not worthy of the protection from the outset. Said another way, the fact that the party (or its attorney or other representative) developed materials as part of routine business practices indicates that the person in question indeed did not prepare the materials in anticipation of litigation.²⁷⁸ The concept has particular

²⁷¹ Special Project, *The Work Product Doctrine*, 68 CORNELL L. REV. 760, 784 (1983).

²⁷² 8 WRIGHT ET AL., *supra* note 223, § 2023, at 329.

²⁷³ Courts and commentators often refer to attorney’s opinions, conclusions, legal theories, and mental impressions as “opinion work product,” *see* Duplan Corp. v. Moulinage et Retordie de Chavanoz, 509 F.2d 730, 731 (4th Cir. 1974); Special Project, *supra* note 271, at 817, while referring to fact work product as “ordinary work product.” *See In re* Murphy, 560 F.2d 326, 329 n.1 (8th Cir. 1977).

²⁷⁴ FED. R. CIV. P. 26(b)(3); *see also* 8 WRIGHT ET AL., *supra* note 223, § 2026, at 405 (“As with all assertions of work-product protection, opinion work product is guarded against discovery only if prepared in anticipation of trial; mental impressions of an attorney in service to other objectives . . . are not protected by the doctrine.”) (footnotes omitted).

²⁷⁵ *See* Robert H. Oberbillig, Note, *Work Product Discovery: A Multifactor Approach to the Anticipation of Litigation Requirement in Federal Rule of Civil Procedure 26(b)(3)*, 66 IOWA L. REV. 1277, 1278 (1981) (stating that the courts’ “methods for redefining the word anticipation do little more than say that litigation is anticipated when litigation is anticipated”).

²⁷⁶ Advisory Committee’s Note, 48 F.R.D. 459, 501 (1970).

²⁷⁷ *See, e.g.*, Thomas Wilson, Note, *The Work Product Doctrine: Why Have an Ordinary Course of Business Exception*, 1988 COLUM. BUS. L. REV. 587, 595.

²⁷⁸ *See, e.g.*, Charles M. Yablon & Steven S. Sparling, *United States v. Adlman: Protection for Corporate Work Product?*, 64 BROOK. L. REV. 627, 649 (1998) (noting that documents prepared in the ordinary course of business “are not exceptions to the work-product

importance in relation to discovery of materials that an enterprise develops for purposes of SFAS No. 5 determinations, as the materials possess aspects of business purposes while at the same time contain characteristics of materials prepared in anticipation of litigation. Courts describe the determination of whether an enterprise (or its attorney or other representative) prepares materials in anticipation of litigation as “clearly a factual determination,”²⁷⁹ and no definite conclusions will arise in the absence of a specific factual background. Three cases, however, provide helpful—though rather disparate—insights into the conclusions a court might reach in determining whether a party prepared SFAS No. 5 materials “in anticipation of litigation.”

i. Primary Motivating Purpose Standard

In *United States v. Gulf Oil Corp.*,²⁸⁰ the court addressed the issue of whether the Department of Energy (“DOE”) could obtain documents that Gulf obtained pursuant to a merger agreement with Cities Service Oil and Gas Corp. (“Cities”). Some of the documents related primarily to an ongoing declaratory judgment case that Cities had brought against the DOE and included letters and memoranda that contained the mental impressions and legal theories of Cities’ in-house counsel. The court described other documents as “prepared for, and at the request of,” Cities’ auditor, Arthur Young & Co.²⁸¹ Although the proposed merger eventually failed, Gulf retained microfilm versions of the documents before returning the originals to Cities.²⁸² After the resolution of the declaratory judgment case and when the DOE began an investigation into some of Cities’ crude oil pricing transactions, DOE attempted to subpoena the documents that Gulf had on microfilm.²⁸³ When Gulf refused to submit some of the requested documents, the DOE brought an enforcement action in the United States District Court for the Southern District of Texas.²⁸⁴ The District Court allowed discovery

rule but simply fail to meet” the standard for work product protection); Wilson, *supra* note 277, at 595 (stating that the “exception is based on a determination that documents created for business purposes are probably not prepared in contemplation of a specific lawsuit”).

²⁷⁹ *Simon v. G.D. Searle & Co.*, 816 F.2d 397, 401 (8th Cir. 1987).

²⁸⁰ 760 F.2d 292 (Temp. Emer. Ct. App. 1985).

²⁸¹ *Id.* at 294.

²⁸² *Id.* at 293.

²⁸³ *Id.* at 294.

²⁸⁴ *Id.* The DOE also brought a subpoena enforcement action against Arthur Young in the District Court for the Northern District of Oklahoma. *See United States v. Arthur Young & Co.*, 1 Fed. R. Serv. 3d (Callaghan) 448 (N.D. Okla. 1984). That court held that most of the documents—including some considered in the Southern District of Texas case—enjoyed work product protection. *See id.* at 453. After the DOE appealed the decision, the parties to the appeal stipulated to a voluntary dismissal. *See Gulf Oil*, 760 F.2d at 294 n.4.

of the items for which the parties claimed an attorney-client privilege, but denied to the DOE discovery of any materials that Gulf claimed enjoyed work product protection.²⁸⁵

On appeal, the Temporary Emergency Court of Appeals affirmed the district court's decision as to those documents that Cities prepared on its own, but reversed and remanded in relation to those documents that Cities prepared for Arthur Young.²⁸⁶ Relying on language from a Fifth Circuit case, the court stated that its "inquiry should be to determine 'the primary motivating purpose behind the creation of the document,'" and to obtain work product protection the primary motivating purpose must have been "to assist in pending or impending litigation."²⁸⁷ Using this inquiry, the court found that Cities had not prepared the documents "to assist Cities in the litigation," but had prepared them "to allow Arthur Young to prepare financial reports" required under the federal securities laws.²⁸⁸

The *Gulf* court found support for its decision in a then-recent decision from the Fifth Circuit that involved an IRS summons for the taxpayer's internally generated "tax-pool analysis" workpapers.²⁸⁹ *El Paso* used the tax-pool analysis to measure potential tax liabilities that would affect the company's financial statements.²⁹⁰ Finding that *El Paso* did not prepare the analysis for "a specific case for trial or negotiation," the *El Paso* court determined that the related workpapers functioned solely to "back up a figure on a financial balance sheet."²⁹¹ As such, the court found that *El Paso* did not prepare the workpapers for the "primary motivating force" of preparing for litigation, but "with an eye on its business needs, not on its legal ones."²⁹²

The *Gulf* court found this reasoning "similarly explicative of why Cities created the documents it delivered to Arthur Young,"²⁹³ and as in *El Paso*, determined Cities prepared the documents for Arthur Young "primarily for the business purpose of compiling financial statements which would satisfy . . . the federal securities laws."²⁹⁴ Therefore, as in *El Paso*, the *Gulf* court held that work product protection did not apply to these documents.

²⁸⁵ *Gulf Oil*, 760 F.2d at 295.

²⁸⁶ *Id.* at 298.

²⁸⁷ *Id.* at 296 (quoting *United States v. Davis*, 636 F.2d 1028, 1040 (5th Cir. 1981)).

²⁸⁸ *Id.* at 297.

²⁸⁹ *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982).

²⁹⁰ *Id.* at 534.

²⁹¹ *Id.* at 544.

²⁹² *Id.* at 543.

²⁹³ *Gulf Oil*, 760 F.2d at 297.

²⁹⁴ *Id.*

ii. *United States v. Adlman: The “Because of” Test*

The Second Circuit recently accepted a more expansive view of work product protection in *United States v. Adlman*.²⁹⁵ In that case, the vice-president of taxes for Sequa Corp. requested that its accountant at Arthur Andersen & Co. prepare a memorandum to “evaluate the tax implications of [a] proposed restructuring.”²⁹⁶ Knowing that the transaction would generate a large tax refund, Sequa wished to obtain an analysis of the likely IRS challenges and a summary of the relevant authorities.²⁹⁷ The resulting fifty-eight page memorandum included possible legal theories and strategies, as well as “recommended preferred methods of structuring the transaction.”²⁹⁸ When the IRS began an investigation, it demanded production of the memorandum. When Sequa refused to produce the document, the IRS brought an enforcement action in the district court for the Southern District of New York.²⁹⁹

After the district court rejected Sequa’s claim for work product protection, Sequa appealed the decision to the Second Circuit. On appeal, the *Adlman* court explicitly rejected the “primary motivating purpose” test that the courts used in the *Gulf* and *El Paso* cases and instead applied a “because of” standard that has been used in the Third, Fourth, Seventh, Eighth, and District of Columbia Circuits.³⁰⁰ Under this “because of” formulation, the work product doctrine protects documents that “can fairly be said to have been prepared or obtained because of the prospect of litigation.”³⁰¹ Under this standard, a document does not lose protection under the work product doctrine merely because the document was created to assist with a business decision. In the court’s view, “the test should be whether, in light of the nature of the document and the factual situation in the particular case, the document can fairly be said to have been prepared or obtained *because of* the prospect of litigation.”³⁰² The *Adlman* court preferred this interpretation, as it found that the primary motivating purpose test worked against the policies underlying the work product doctrine.³⁰³ The *Adlman* court also stated that the *El Paso* and *Gulf* courts requirement that the materials had to be prepared to aid in litigation went against the language of the

²⁹⁵ 134 F.3d 1194 (2d Cir. 1998).

²⁹⁶ *Id.* at 1195.

²⁹⁷ *Id.*

²⁹⁸ *Id.*

²⁹⁹ *Id.* at 1196.

³⁰⁰ *Id.* at 1198, 1202.

³⁰¹ 8 WRIGHT ET AL., *supra* note 223, § 2024, at 343.

³⁰² *Id.*

³⁰³ *Adlman*, 134 F. 3d at 1200.

Rule.³⁰⁴ The court, therefore, determined that merely because a party prepares a document to assist in a business decision, work product protection remains where the document "is created because of the prospect of litigation."³⁰⁵

The *Adlman* court also provided some insight into the ordinary course of business issue. In this regard, the court recognized that its interpretation of "in anticipation of litigation" does not protect documents "prepared in the ordinary course of business or that would have been created in essentially similar form irrespective of the litigation."³⁰⁶ Noting the statement in the Advisory Committee's note to Rule 26(b)(3),³⁰⁷ the court stated that "[e]ven if such documents . . . help in preparation for litigation, they do not qualify for protection because it could not be fairly said that they were created 'because of' . . . litigation."³⁰⁸ In remanding the case to the district court, the *Adlman* court provided the following formulation to guide the district court in determining whether the memorandum was prepared in the ordinary course of business: "[i]f the district court concludes that substantially the same Memorandum would have been prepared in any event . . . then the court should conclude the memorandum was not prepared because of the expected litigation," and therefore should withhold work product protection.³⁰⁹ Even in such circumstances, however, the district court retains "the authority to protect against disclosure of the mental impressions, strategies, and analyses of the party or its representative concerning the litigation."³¹⁰

iii. *Simon v. G.D. Searle & Co.: The Middle of the Gulf/Adlman Spectrum*

Although the *Adlman* court presented the "primary motivating purpose" and the "because of" tests as being mutually exclusive, courts that had already adopted the "because of" formulation still sometimes introduced concepts of primary motivating purpose analysis to reach a conclusion regarding the "in anticipation of litigation" requirement.³¹¹ The inconsistency is not surprising

³⁰⁴ *Id.* at 1198 ("If the drafters . . . intended to limit its protection to documents made to assist in preparation for litigation, this would have been adequately conveyed by the phrase 'prepared . . . for trial'" (second ellipses in original) (quoting FED. R. CIV. P. 26(b)(3)).

³⁰⁵ *Id.* at 1202.

³⁰⁶ *Id.*

³⁰⁷ Advisory Committee's Note, 48 F.R.D. 487, 501 (1970) ("Materials assembled in the ordinary course of business . . . are not under the qualified immunity provided by this subdivision.").

³⁰⁸ *Adlman*, 134 F.3d at 1202.

³⁰⁹ *Id.* at 1204.

³¹⁰ *Id.* at 1202-03.

³¹¹ See *Nat'l Union Fire Ins. v. Murray Sheet Metal Co.*, 967 F.2d 980, 984 (4th Cir.

because stating that a party created a document “because of” litigation is not easy when the document has dual purposes. In *Simon*, the Eighth Circuit dealt with just such a situation where it had to determine the discoverability of documents generated by the risk management department of G.D. Searle & Co. (“Searle”).³¹²

The risk management department utilized individual case reserve figures, which the corporation’s legal department supplied, to monitor the corporation’s products liability litigation and its litigation reserves.³¹³ The risk management department used the individual case reserves to generate aggregate case reserve summaries for use in financial planning.³¹⁴ In determining whether the opposing party could discover the documentation related to the reserves, the court relied on the “because of” formulation to arrive at two conclusions: (1) the work product doctrine protected the individual case reserve figures and related documentation; and (2) the aggregate case reserve figures and documentation constituted work product only “to the extent that they disclose the individual case reserves calculated by Searle’s attorneys.”³¹⁵

The *Simon* court noted that “the individual case reserves reveal the mental impressions, thoughts, and conclusions of an attorney,” and that “by their very nature they are prepared in anticipation of litigation.”³¹⁶ Recognizing that the work product doctrine was designed to prevent “unwarranted inquiries into the files and mental impressions of an attorney,”³¹⁷ the court determined that the work product doctrine protected any documents that contained information related to individual case reserves.³¹⁸ The court found, however, that the aggregate case reserves did not reveal the individual case reserve figures “to a degree that brings [them] within the protection of the work product doctrine.”³¹⁹

1992) (using explicitly the “because of” formulation, but then stating that the court must “[d]etermin[e] the driving force behind the preparation” of each document); *Simon v. G.D. Searle & Co.*, 816 F.2d 397, 401 (8th Cir. 1987) (using the “because of” test, but noting that the requested documents were “in the nature of business planning documents”); *Binks Mfg. Co. v. Nat’l Presto Indus.*, 709 F.2d 1109, 1118–19 (7th Cir. 1983) (using the “because of” test but inquiring into the “motivating factor” behind the creation of the document). *See generally* Yablon & Sparling, *supra* note 278, at 646 n.121 (noting the inconsistencies and stating that “[a] more accurate couching . . . depicts *El Paso* and *Adlman* as existing on different ends of the anticipation of litigation spectrum”).

³¹² *Searle*, 816 F.2d at 399.

³¹³ *Id.*

³¹⁴ *Id.* at 400–01.

³¹⁵ *Id.* at 401–02.

³¹⁶ *Id.* at 401.

³¹⁷ *Id.* at 400 (quoting *Hickman v. Taylor*, 329 U.S. 495, 510 (1947)).

³¹⁸ *Searle*, 816 F.2d at 401.

³¹⁹ *Id.* at 402.

Because the individual figures "lose their identity" when included in aggregate amounts, the court held that the work product doctrine did not prevent discovery of documents that "incorporate a lawyer's thoughts in, at best, such an indirect and diluted manner."³²⁰ Although the *Simon* court did allow discovery of the aggregate reserve documents, one has to question just how much such documentation could help the opposing attorney's case. Because the documents would have no indication of the specific case, the only purpose they might have would be to shed light on how Searle treats cases of a similar kind as a whole.

b. Waiver

Because the work product doctrine prevents disclosure to the opposing party and counsel, transmission of work product to third parties, including accountants, may not waive the protection. In fact, courts have split as to whether disclosures to independent auditors waive the work product protection.³²¹ In addition, several courts have concluded that communications concerning individual case reserves qualified for work product protection, while ordering defendants to produce information regarding aggregate reserve figures.³²²

³²⁰ *Id.* (footnote omitted).

³²¹ Compare *In re Pfizer, Inc. Sec. Litig.*, No. 90 Civ. 1260(SS), 1993 WL 561125, at *6 (S.D.N.Y. Dec. 23, 1993) (concluding that disclosure to independent auditor did not waive work product protection, but eliminated argument that attorney-client privilege applied), and *Gramm v. Horsehead Indus., Inc.*, No. 87 CIV. 5122(MJL), 1990 WL 142404, at *4-6 (S.D.N.Y. Jan. 25, 1990) (concluding that disclosure to an accounting firm which did not work on matters related to the case did not waive work product rule), with *In re Diasonics Sec. Litig.*, No. C-83-4584-RFP(FW), 1986 WL 53402, at *1 (N.D. Cal. June 15, 1986) (reasoning at least in part that although disclosure to someone sharing a common interest under a guarantee of confidentiality does not necessarily waive the work product protection, an independent accountant's responsibilities to creditors and the investing public transcend any such guarantee), and *United States v. Mass. Inst. of Tech.*, 129 F.3d 681, 687 (1st Cir. 1997) (listing five circuits that have adopted the rule that disclosure to a non-adversary does not waive work product protection, restating the prevailing rule as "disclosure to an adversary, real or potential, forfeits work product protection," and treating the disclosure to the Defense Contract Audit Agency as "disclosure to a potential adversary"). In the *Diasonics* case, plaintiffs filed a motion to compel Arthur Young & Co. to produce documents prepared by or disclosed to Diasonics' auditor so that the accounting firm could assess how pending litigation, including the underlying lawsuit, would affect Diasonics' financial condition. The court granted the motion, finding that neither the attorney-client privilege nor the work product doctrine excused production because the documents "were generated for the business purpose of creating financial statements which would satisfy the requirements of the federal securities laws and not to assist in litigation." *In re Diasonics*, 1986 WL 53402, at *1.

³²² See, e.g., *Simon v. G.D. Searle & Co.*, 816 F.2d 397 (8th Cir. 1987) (ruling that risk management documents prepared by corporate officials to aggregate information from individual case reserve figures obtained from the company's legal department were not

2. *Limitations on the Scope of Discovery*

Given the potential value of this information regarding litigation reserves and contingencies, plaintiffs should expect that defendants and third parties will seek to resist discovery requests even when the requested information qualifies as “relevant” and “not privileged.” At a minimum, the recipients of requests will attempt to narrow the range of requested discovery. Although Rule 26(b)(1) establishes a very broad scope of discovery, Rule 26(b)(2) gives the trial judge broad powers to regulate or prevent discovery even though the materials sought fall within the scope of Rule 26(b)(1). In that regard, Rule 26(b)(2) authorizes a court to limit the frequency or extent of the use of the discovery methods otherwise permitted if the court

determines that: (i) the discovery sought is unreasonably cumulative or duplicative, or is obtainable from some other source that is more convenient, less burdensome, or less expensive; (ii) the party seeking discovery has had ample opportunity by discovery in the action to obtain the information sought; or (iii) the burden or expense of the proposed discovery outweighs its likely benefit, taking into account the needs of the case, the amount in controversy, the parties’ resources, the importance of issues at stake in the litigation, and the importance of the proposed discovery in resolving the issues.³²³

Courts have historically and freely exercised these powers.³²⁴ As a result, a litigation opponent or third party may try to quash or otherwise avoid discovery on several possible grounds: irrelevancy, undue burden or excessive cost, privilege, or work product.

protected from discovery by the work product doctrine in product liability action against intrauterine contraceptive device manufacturer); *Gen. Electric Capital Corp. v. DirectTV, Inc.*, 184 F.R.D. 32, 34–36 (D. Conn. 1998) (drawing a distinction between individual case reserves and aggregate figures and concluding, after in camera review, that five documents pertaining to defendants’ loss reserves were both relevant and not privileged under either the work product doctrine or the attorney-client privilege); *In re Pfizer, Inc.*, 1993 WL 561125, at *3–5 (concluding that documents containing individual case reserve figures could qualify for both work product protection and the attorney-client privilege in class action suit under federal securities laws).

³²³ FED. R. CIV. P. 26(b)(2).

³²⁴ Although no privilege protects a party’s income tax return, “courts have recognized that interests in privacy may call for . . . extra protection.” FED. R. CIV. P. 26 advisory committee’s note to 1970 amendment to subdivision (b).

C. Potential Admissibility

Dictum from at least one court suggests that information about litigation reserves might even qualify as admissible evidence. In *In re Amino Acid Lysine Antitrust Litigation*,³²⁵ the United States District Court for the Northern District of Illinois ordered disclosure of any reserves that defendant Archer-Daniels-Midland Co. had established for the underlying antitrust litigation before the court would rule that the proposed settlement in the class action fell within the range of fairness, reasonableness, and adequacy. The judge wrote:

In this Court's experience in representing public companies, or in separately representing the outside directors of public companies, it has found such reserves to be a material indicium of the fair value of a liability, estimated by those who are presumably in the best position to make such an evaluation.³²⁶

In contrast, some courts have explicitly rejected the argument that a defendant waives the right to deny liability by accruing an expense or loss on a claim.³²⁷ To the extent that the defendant's accounting policies interpret the term "probable" to mean at least an eighty percent chance of an unfavorable outcome,³²⁸ the arguments for admissibility get much stronger. By comparison, if the defendant's accounting policies treat "probable" as "anything greater than fifty percent,"³²⁹ the danger of unfair prejudice arguably substantially outweighs the accrual's probative value.³³⁰

V. CONCLUSION AND REFORM PROPOSAL

By accruing an expense and recording a litigation reserve related to an underlying lawsuit, undergoing an audit, or providing some bland disclosure in a public report, this article warns that an enterprise could both waive the right to claim privilege and lose work product protection for any information disclosed to its auditor in any litigation involving a federal issue, such as the federal antitrust,

³²⁵ No. 95 C 7679, 1996 WL 197671 (N.D. Ill. Apr. 22, 1996).

³²⁶ *Id.* at *5.

³²⁷ See, e.g., *Cont'l Ins. Co. v. Beecham, Inc.*, 836 F. Supp. 1027, 1047 n.12 (D.N.J. 1993) (ruling that an insurer's establishment of a reserve did not constitute an admission in a policy coverage dispute).

³²⁸ See *supra* note 40.

³²⁹ See *supra* note 39 and accompanying text.

³³⁰ See FED. R. EVID. 403 ("Although relevant, evidence may be excluded if its probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues, or misleading the jury, or by considerations of undue delay, waste of time, or needless presentation of cumulative evidence.").

environmental, or securities laws. Thus, via discovery requests and subpoena, opposing counsel could obtain the enterprise's own documentation regarding litigation contingencies, plus whatever information an independent auditor might have incorporated in the working papers or otherwise gathered during the audit, for use at trial or during settlement negotiations. As a result, an opponent in litigation can potentially gain access to significant information about the assessments of an enterprise, its auditor, and its attorney about the enterprise's exposure in the litigation, potentially evidenced by amounts that the enterprise has already accrued as an expense, but not yet paid, related to the underlying litigation.

Given these realities, the legal profession, the business community, including the accounting profession, and the academy should ask whether any public policies, including those underlying discovery of all relevant information in advance of trial,³³¹ "full disclosure" under the federal securities laws,³³² and the preferred settlement, whenever possible, of lawsuits outside the judicial system,³³³ justify the existence and use of these discovery opportunities. After weighing those policies and an appropriate study, the Advisory Committee on the Federal Rules of Evidence should recommend that the Supreme Court adopt a new rule of evidence that, similar to Rule 411 on liability insurance,³³⁴ would

³³¹ See generally Stephen N. Subrin, *Fishing Expeditions Allowed: The Historical Background of the 1938 Federal Discovery Rules*, 39 B.C. L. REV. 691 (1998). The drafters of the original discovery rules intended the rules to result in more uniform discovery practices, to allow greater clarity in defining the contested issues, and to eliminate the element of surprise, allowing lawyers to better prepare for trial. *Id.* at 702-10 (citing GEORGE RAGLAND, JR., *DISCOVERY BEFORE TRIAL* 266 (1932)). In *Hickman v. Taylor*, 329 U.S. 495 (1947), the Supreme Court recognized that proper litigation requires that parties have access to the information that can provide them with a "mutual knowledge of all of the relevant facts." *Id.* at 507.

³³² See *supra* note 155 and accompanying text.

³³³ See, e.g., Leandra Lederman, *Precedent Lost: Why Encourage Settlement, and Why Permit Non-Party Involvement in Settlements*, 75 NOTRE DAME L. REV. 221, 257-63 (1999) (describing various legal rules and policy reasons to encourage settlement of lawsuits). Any policy discussion should also weigh another consideration: while discoverability of information about litigation reserves might encourage some cases to settle, it might also encourage litigants to file actions or claims that they might not otherwise bring in an effort to determine whether an opponent has recorded a litigation reserve.

³³⁴ Rule 411 of the Federal Rules of Evidence provides:

Evidence that a person was or was not insured against liability is not admissible upon the issue whether the person acted negligently or otherwise wrongfully. This rule does not require the exclusion of evidence of insurance against liability when offered for another purpose, such as proof of agency, ownership, or control, or bias or prejudice of a witness.

allow the discovery of information related to litigation reserves and litigation contingencies, but would bar its admission into evidence at trial on the issues of whether the enterprise has admitted liability on the claim or the amount of liability.

Discovery seeks to provide a mechanism that allows the litigants to obtain all relevant information. In *Hickman v. Taylor*,³³⁵ the landmark case that recognized the work product doctrine, the Supreme Court stated that “[m]utual knowledge of all the relevant facts gathered by both parties is essential to proper litigation.”³³⁶ Accordingly, the Federal Rules contemplate a discovery process that facilitates “a broad search for facts, the names of witnesses, or any other matters [that] may aid [parties] in the preparation or presentation of [their] case[s].”³³⁷

In 1970, the Supreme Court promulgated comprehensive amendments to the discovery rules in the Federal Rules of Civil Procedure.³³⁸ As one of the most significant changes, the 1970 amendments to then-Rule 26(b)(2) allowed parties to discover the contents of insurance policies.³³⁹ Subsequent amendments in 1993 moved this provision to Rule 26(a)(1)(D) and revised the rule to require disclosure of the insurance policy itself.³⁴⁰ Before the 1970 amendments, both judicial decisions and commentators had split on the question of whether parties could discover insurance policies when the insurance coverage was not admissible and did not bear on any other issue in the case.³⁴¹ “The cases favoring disclosure rel[ie]d heavily on the practical significance of insurance in the decisions that lawyers reach about settlement and trial preparation.”³⁴² The Advisory Committee on the Federal Rules for Civil Procedure, and presumably the Supreme Court, concluded that “disclosure of insurance coverage [would] enable counsel for both sides to make the same realistic appraisal of the case, so that [they could base] settlement and litigation strategy . . . on knowledge, not speculation.”³⁴³ The Advisory Committee further believed that such disclosure would sometimes advance settlement and avoid protracted litigation.³⁴⁴ At the same time, the Advisory Committee stressed that “[i]n no instance does

³³⁵ 329 U.S. 495 (1947).

³³⁶ *Id.* at 507.

³³⁷ FED. R. CIV. P. 26 advisory committee’s notes to 1946 amendment to subdivision (b).

³³⁸ FED. R. CIV. P. pt. V. advisory committee’s explanatory statement concerning 1970 amendments to discovery rules (section on “Depositions and Discovery”).

³³⁹ FED. R. CIV. P. 26(b)(2) advisory committee’s notes to 1970 amendment.

³⁴⁰ FED. R. CIV. P. 26(a)(1)(D) and advisory committee’s notes to 1993 amendment.

³⁴¹ FED. R. CIV. P. 26(b)(2) advisory committee’s notes to 1970 amendment.

³⁴² *Id.*

³⁴³ *Id.*

³⁴⁴ *Id.*

disclosure make the facts concerning insurance coverage admissible in evidence.”³⁴⁵

In its explanation of the 1970 amendments, the Advisory Committee deliberately limited the new rule to insurance coverage. In that regard, the Advisory Committee stated that the new rule does not apply to a business concern that creates a reserve fund for purposes of self-insurance.³⁴⁶ When establishing a litigation reserve, enterprises only rarely, if ever, also set funds aside to satisfy the underlying liability.³⁴⁷ As a result, the exception to the rule requiring disclosure of insurance policies for reserve funds does not apply to litigation reserves.³⁴⁸

The Advisory Committee also specifically stated that the new rule did not apply to any other facts concerning the defendant’s financial status for several reasons. First, the Advisory Committee considered insurance as an asset, albeit not in the financial accounting sense, created specifically to satisfy the claim. Second, the insurance company ordinarily controls the litigation. Third, a litigant can obtain information about coverage only from the defendant or the insurer. Finally, disclosure about insurance does not involve a significant invasion of privacy.

These same justifications also support the discovery of litigation reserves. First, under SFAS No. 5 any accrual or disclosure related to a litigation

³⁴⁵ *Id.*

³⁴⁶ *Id.*

³⁴⁷ See *supra* note 4.

³⁴⁸ If an enterprise has actually both set aside cash or other liquid assets by establishing a formal escrow arrangement or opening a special bank account and specifically earmarked those assets for discharging obligations arising from particular litigation, such designation arguably comes extremely close to admitting liability in the underlying lawsuit. Such a situation could eventually lead to either an admission under Rule 36 of the Federal Rules of Civil Procedure or admissible evidence as either an admission by a party-opponent, or so-called “declaration against interest,” specifically excluded from the definition of hearsay under Rule 801(d)(2)(A) of the Federal Rules of Evidence, or an exception to the hearsay rule as a statement against interest under Rule 804(b)(3) of the Federal Rules of Evidence. An alternative interpretation would allow the opponent in litigation to discover only information regarding the litigation reserve and any related expense.

A “declaration against interest” includes both verbal statements and non-verbal actions. Such statements generally qualify without regard to surrounding circumstances. CHRISTOPHER B. MUELLER & LAIRD C. KIRKPATRICK, EVIDENCE § 8.27, at 865 (2d ed. 1999). Consequently, the declaration against interest rule has “almost infinite breadth.” *Id.* at 866 (citation omitted). In addition, Rule 801(d)(2)(A) does not require that the declaration be against interest when it was made. *Id.* A finding that a statement or behavior falls under the “declaration against interest” rule, however, does not automatically require its admissibility. Rule 403 of the Federal Rules of Evidence, for example, allows exclusion of an admission if, among other risks, the risk of unfair prejudice outweighs the statement’s probative value. FED. R. EVID. 403.

contingency must involve at least one particular claim.³⁴⁹ Second, accounting practice has long placed the responsibility for an enterprise's financial statements on management.³⁵⁰ As a result, the enterprise's management decides in the first instance whether to accrue an expense related to a litigation contingency or to disclose that contingency in the notes to the financial statements. Although an auditor may refuse to render an unqualified opinion on the financial statements unless management records an adjustment or adds certain disclosures, the financial statements remain the representations of management.³⁵¹ Third, a party can generally obtain information about an opponent's litigation reserves only from the enterprise or the enterprise's auditor.³⁵² Finally, especially for registrants that must file financial statements and periodic reports with the SEC, disclosure during discovery does not involve a significant invasion of privacy.³⁵³ At the same time, any disclosure in discovery, at least by itself, should not become admissible in evidence or constitute a waiver of the enterprise's defenses or litigating position.

³⁴⁹ See *supra* notes 49–58 and accompanying text.

³⁵⁰ HERWITZ & BARRETT, *supra* note *, at 173.

³⁵¹ *Id.*

³⁵² If the enterprise's management discusses a litigation reserve or litigation contingency with a financial analyst or investment banker, or provides documentation regarding such matters to such individuals, the litigation opponent could potentially discover those communications from those individuals. Any such disclosures, however, would seemingly waive any privileges and significantly weaken any claims to work product protection.

³⁵³ At some point, the Advisory Committee on the Federal Rules of Civil Procedure may want to consider an amendment to those rules to require parties to disclose any litigation reserves related to an underlying lawsuit under Rule 26(a)(1). Because such a rule would apply to all parties, including enterprises not subject to the SEC's periodic reporting requirements, such an amendment to Rule 26(a)(1) also raises privacy concerns.